

February 24, 2006



Financial Management

DoD Process for Reporting Contingent Legal Liabilities (D-2006-054)

Department of Defense
Office of Inspector General

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Acronyms

ABA	American Bar Association
DFAS	Defense Finance and Accounting Service
GAO	Government Accountability Office
OMB	Office of Management and Budget
SFFAS	Statement of Federal Financial Accounting Standards
USACE	U.S. Army Corps of Engineers



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February 24, 2006

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)/
CHIEF FINANCIAL OFFICER
GENERAL COUNSEL OF THE DEPARTMENT OF
DEFENSE
ASSISTANT SECRETARY OF THE AIR FORCE
(FINANCIAL MANAGEMENT AND COMPTROLLER)
NAVAL INSPECTOR GENERAL
AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Report on the DoD Process for Reporting Contingent Legal Liabilities
(Report No. D-2006-054)

We are providing this report for review and comment. We performed the audit as part of our continuing audit work in support of the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. We considered management comments on the draft of this report when preparing the final report. The complete text of the comments is in the Management Comments section of the report.

Comments from the Army, Air Force, and U.S. Army Corps of Engineers were generally responsive. Comments from the DoD Deputy Chief Financial Officer were also generally responsive, except for Recommendation 1. Comments by the DoD Deputy General Counsel (Fiscal) and the Navy were not responsive. DoD Directive 7650.3 requires that all issues be resolved promptly. Because this audit supports our annual audits of the DoD and its major Components' financial statements, it is important to realize that failure to address the concerns discussed in this report may prevent DoD from obtaining a favorable audit opinion in the future. We request that the Under Secretary of Defense (Comptroller)/Chief Financial Officer take the lead in implementing Recommendation 1 and provide additional comments to the final report by March 24, 2006, on how she plans to implement this recommendation. We have decided not to request additional comments from the Navy. As part of our annual audits, we will address specific material deficiencies related to contingent legal liabilities in the Navy and other DoD Components' financial statements.

If possible, please send management comments in electronic format (Adobe Acrobat file only) to Auddfs@dodig.mil. Copies of management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature. We appreciate the courtesies extended to the staff. Questions should be directed to Mr. Marvin L. Peek at (703) 325-5777 (DSN 221-5777) or Mr. Scott S. Brittingham at (703) 325-6104 (DSN 221-6104). See Appendix D for the report distribution. The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

A handwritten signature in black ink, reading "Paul J. Granetto", is positioned above the printed name.

Paul J. Granetto, CPA
Assistant Inspector General
Defense Financial Auditing
Service

Department of Defense Office of Inspector General

Report No. D-2006-054

February 24, 2006

(Project No. D2004-D000FA-0202.000)

DoD Process for Reporting Contingent Legal Liabilities

Executive Summary

Who Should Read This Report and Why? Personnel within the Office of the Secretary of Defense, other DoD Components responsible for preparing the annual financial statements, and legal counsel who provide legal representations regarding contingent liabilities should read this report. It identifies areas where DoD and its Components have not fully complied with Federal financial accounting standards and are not consistent in computing and disclosing contingent legal liabilities. The report is intended to convey systemic concerns across DoD and to provide DoD management and legal counsel the basis for developing policies and procedures for reporting and disclosing contingent legal liabilities in accordance with Federal financial accounting and reporting requirements.

Background. We performed the audit as part of our continuing audit work in support of the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. Auditing standards require auditors to obtain information from management, supported by legal counsel, regarding pending or threatened litigation and unasserted claims and assessments that could result in a potential loss material to the financial statements. The Government Accountability Office, which audits the U.S. Government's consolidated financial statements, expressed concern that DoD is not providing the required evidential matter to support statements it is making about pending or threatened litigation, possible claims, and assessments against the Government in DoD financial statements.

Results. The DoD process for evaluating pending litigation, claims, and assessments, and reporting contingent legal liabilities does not sufficiently satisfy the intent of Federal financial accounting and reporting requirements. Specifically:

- Legal representation letters did not provide meaningful assessments or support accruals and disclosures in the financial statements for the DoD Components;
- DoD Components did not report contingent legal liabilities in a consistent manner; and
- DoD Components did not assess and disclose the effects of uncertainties on the financial statements when legal counsel was unable to determine the likelihood of loss.

In addition, DoD did not report on immaterial cases that, in aggregate, exceeded established materiality thresholds. As a result, DoD representations do not contain sufficient evidence to assess the validity of the presentation or disclosure of legal loss contingencies on the financial statements. DoD needs to develop solutions and uniform methodology to ensure that it provides meaningful and supported assessments of all contingent legal liabilities for presentation on its financial statements, as appropriate. If

the risks and uncertainties for contingent legal liabilities are not adequately assessed, supported, and disclosed on the financial statements, DoD (and perhaps the Federal Government) will not be able to receive a favorable opinion on future financial statements. (See the Finding section for the detailed recommendations.)

Management Comments and Audit Response. The DoD Deputy Chief Financial Officer and DoD Deputy General Counsel (Fiscal) partially concurred with the recommendation to establish a forum, with involvement by financial management and legal counsel, to develop solutions and uniform methods amicable to all parties so that DoD and its major Components fully satisfy the intent of Federal financial accounting and reporting requirements for contingent legal liabilities. The DoD Deputy General Counsel (Fiscal) nonconcurred with the recommendation to develop uniform estimating and aggregating methodology. The DoD Deputy Chief Financial Officer partially concurred with the recommendation to revise the DoD Financial Management Regulation to ensure consistent application of requirements across the DoD and consistent disclosure of all contingent legal liabilities considered material to financial statements. Comments by the DoD Deputy Chief Financial Officer concerning revising the regulation are responsive. All other comments by the Deputies are not responsive.

The Deputies appeared to be more interested in standardized reporting across the Federal Government than in addressing the issues identified by the report that are specific to DoD. We also are interested in more uniformity within the Federal Government regarding evaluation and disclosure of material contingent legal liabilities. However, as the auditors of the DoD financial statements, it is our responsibility to evaluate the support for those statements and their adherence to Federal financial accounting standards. Because the Chief Financial Officer has the responsibility to ensure that DoD follows Federal financial accounting standards, we have revised Recommendation 1 to make the Under Secretary of Defense (Comptroller)/Chief Financial Officer the lead for implementing the recommendation. We request that the Under Secretary of Defense (Comptroller)/Chief Financial Officer provide additional comments that address the means her office will use to develop DoD solutions for providing assessments in accordance with Statement of Federal Financial Accounting Standards No. 5, “Accounting for Liabilities of the Federal Government,” as amended. The comments should also address how DoD will develop and implement a uniform methodology for estimating, aggregating, and reporting contingent legal liabilities. We request that the Under Secretary of Defense (Comptroller)/Chief Financial Officer provide the comments by March 24, 2006.

The DoD Deputy Chief Financial Officer, Army, Navy, Air Force, and U.S. Army Corps of Engineers concurred with the recommendation to ensure accruals and disclosures of contingent legal liabilities are fully supported and agree with legal representations. The DoD Deputy Chief Financial Officer, Army, Air Force, and U.S. Army Corps of Engineers concurred and the Navy nonconcurred with the recommendation to review, approve, and disclose estimation methodologies. The U.S. Army Corps of Engineers concurred, the DoD Deputy Chief Financial Officer and Army partially concurred, and the Navy and Air Force nonconcurred with the recommendation to disclose the dollar value of claims in which legal counsel was “unable to express an opinion” concerning case outcome or estimate of liability if such claims are material to the financial statements.

Although not required to comment, the DoD Deputy General Counsel (Fiscal) did not believe that all information in financial statement footnotes must be in legal representation letters. He indicated that other information not in legal representation letters could be disclosed in footnotes if such information is distinguished from legal

letter information. He also indicated no obstacle to presenting information developed from estimation methodologies or related to legal uncertainties if made clear that the information was not based on attorney evaluations. However, he questioned the utility of such information. Comments from the Army and U.S. Army Corps of Engineers are responsive. Although the Air Force nonconcurred, we consider its comments responsive because the Air Force uses a methodology to estimate potential losses resulting from contingent legal liabilities. Comments by the DoD Deputy Chief Financial Officer are partially responsive, and comments by the Navy are not responsive.

We do not believe that the Navy fully considered the magnitude of potential legal claims in making accrual and disclosure determinations for contingent legal liabilities. Further, it is not clear whether the Office of the Under Secretary of Defense (Comptroller) or Navy will determine whether legal uncertainties in which legal counsel was “unable to express an opinion” have a material affect on the financial statements and should be disclosed. However, because review of contingent legal liabilities is part of our annual audit of the annual financial statements for DoD and its major Components, we have decided not to request additional comments from the Under Secretary of Defense (Comptroller)/Chief Financial Officer or the Navy. We will continue to work with DoD and the Navy as well as all DoD Components to ensure contingent legal liabilities are appropriately disclosed in the financial statements.

See the Finding section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

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Background

We performed the audit as part of our continuing audit work in support of the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. The Government Accountability Office (GAO), as the responsible auditors for U.S. Government's Consolidated Financial Statements, expressed concern about the adequacy of DoD legal representations for its contingent legal liabilities.

DoD Reporting Entities. The Office of Management and Budget (OMB) requires DoD to prepare audited financial statements for the Army General and Working Capital Funds, Navy General and Working Capital Funds, Air Force General and Working Capital Funds, Military Retirement Trust Fund, and the U.S. Army Corps of Engineers Civil Works Program (USACE). In addition, DoD reports on the Other Defense Organizations' General and Working Capital Funds and Medicare Eligible Retiree Health Care Fund, which are also included in the DoD Agency-Wide Financial Statements.

Contingent Legal Liabilities. A contingent legal liability arises from pending or threatened litigation, possible claims, and assessments which could result in monetary loss to an entity. DoD contingent legal liabilities arise from litigation, claims, and assessments stemming from events such as aircraft, ship, and vehicle accidents; medical malpractice; property or environmental damages; and contract disputes. The actual monetary liability in contingent legal cases can be considered case-by-case or as an aggregate of multiple cases.

The Statement of Federal Financial Accounting Standards (SFFAS) No. 5, "Accounting for Liabilities of the Federal Government," as amended by SFFAS No. 12, "Recognition of Contingent Liabilities Arising From Litigation," classifies the likelihood of loss as "probable" (likely to occur), "reasonably possible" (more than "remote" but less than likely), or "remote" (slight chance of occurring). The classification determines whether contingent legal liabilities are recorded, disclosed, or not reported in financial statements.

DoD Reporting Procedures for Contingent Legal Liabilities. DoD Auditors request a legal representation letter from each audited entity disclosing contingent legal liabilities. The appropriate General Counsel for each audited entity provides the auditors with information concerning contingent legal liabilities arising from pending or threatened litigation or other possible claims. Because the DoD Agency-Wide Financial Statements are comprised of a compilation of the various components of DoD, the DoD Office of General Counsel normally uses the same information provided by the General Counsels of the DoD components, except that the DoD Office of General Counsel uses a higher materiality threshold for reporting based on the DoD Agency-Wide Financial Statements. For FY 2004 and FY 2005, the materiality thresholds for disclosure of individual and aggregated legal claims for the audit of the DoD Agency-Wide Financial Statements were \$100.7 million and \$171.4 million, respectively. In response to our request during the audit of the FY 2004 DoD Agency-Wide Financial Statements, the DoD Office of General Counsel included potential legal claims of \$364.6 billion.

Objectives

Our overall audit objective was to assess the DoD process to ensure that contingent legal liabilities are accurately and completely reported and disclosed within financial statements, in accordance with Federal financial accounting standards. Specifically, we examined policies and procedures for identifying, tracking, estimating, and reporting contingent legal liabilities. In addition, we evaluated information presented in legal representation letters and related management summaries. We also reviewed the management control program as it related to the overall objective. See Appendix A for a discussion of the scope and methodology. See Appendix B for prior coverage related to the objectives.

Management Control Program Review

DoD Directive 5010.38, “Management Control (MC) Program,” August 26, 1996, and DoD Instruction 5010.40, “Management Control (MC) Program Procedures,” August 28, 1996, require DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of the Review of the Management Control Program. We reviewed management controls over reporting and disclosing contingent legal liabilities in accordance with Federal financial accounting and reporting requirements. We also reviewed the adequacy of management’s self-evaluation of those controls.

Adequacy of Management Controls. We identified a material management control weakness for the DoD, as defined by DoD Instruction 5010.40. The controls did not ensure that sufficient evidence supported the presentation and disclosure of legal loss contingencies on the DoD financial statements. Recommendations, if implemented, will correct the identified weakness and could result in enhanced visibility over contingent legal liabilities. A copy of the report will be provided to the senior officials responsible for management controls in the DoD and the Military Departments.

Adequacy of Management’s Self-Evaluation. DoD officials did not identify legal representations and contingent legal liabilities as an assessable unit and, therefore, did not identify or report the material management control weakness identified by the audit.

Reporting and Support for Contingent Legal Liabilities

The DoD process for evaluating pending litigation, claims, and assessments, and reporting contingent legal liabilities does not sufficiently satisfy the intent of Federal financial accounting and reporting requirements. Specifically:

- Legal representation letters did not provide meaningful assessments or support accruals and disclosures in the financial statements for the DoD Components.
- DoD Components did not report contingent legal liabilities in a consistent manner.
- DoD Components did not always assess and disclose the effects of uncertainties on the financial statements when legal counsel was unable to determine the likelihood of loss.

In addition, DoD did not report on immaterial cases that, in aggregate, exceeded materiality thresholds established by the auditors. DoD has not adopted policies and procedures in conformity with Federal financial accounting standards to provide assurance that it consistently evaluates, estimates, and accounts for litigation, claims, and assessments when preparing its financial statements. DoD management has not taken ownership over the process, bridging the gaps between financial accounting and reporting requirements, audit requirements, and guidance issued by the American Bar Association. As a result, the DoD and its Components' representations do not contain sufficient evidence for auditors to assess the presentation or disclosure of legal loss contingencies on the DoD financial statements. If the risks and uncertainties for contingent legal liabilities are not adequately assessed, supported, and disclosed on the financial statements, DoD (and perhaps the Federal Government) will not be able to receive a favorable opinion on future financial statements.

Reporting Requirements

Federal financial accounting standards require DoD to assess contingent legal liabilities and report whether the liabilities are "probable," "reasonably possible," or "remote." Specifically, SFFAS No. 5, as amended, requires DoD to:

- report a contingent legal liability on the balance sheet when an unfavorable outcome is "probable," and
- disclose a contingent legal liability in the notes to the financial statements when an unfavorable outcome is "reasonably possible."

No disclosure is required if the loss from a contingent legal liability is considered “remote.”

SFFAS No. 5, as amended, requires DoD to describe the nature of the contingent legal liabilities in its financial statement footnotes and include estimates of the possible liabilities or state that estimates cannot be made. To make assessments, financial management consults with legal counsel concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments, and the amount or range of potential monetary loss.

Legal counsel evaluates the likely outcome of litigation, claims, and assessments and estimates the potential monetary loss for cases in which an unfavorable outcome is “probable” or “reasonably possible.” OMB¹ requires that the Chief Financial Officer assess each case reported in the legal representation letter and prepare a management schedule showing its decisions on how such information will be reported and disclosed, as applicable. This assessment extends to cases in which legal counsel is “unable to express an opinion” as to the likelihood of loss.

Auditors ordinarily do not possess skills to make legal judgments concerning contingent legal liabilities. Therefore, they rely on representations made by management and counsel. In accordance with OMB reporting requirements, DoD legal counsel and the DoD Chief Financial Officer are required to furnish legal representation letters and management summary schedules, respectively, to auditors as a means for auditors to corroborate the accuracy and completeness of contingent legal liabilities reported and disclosed in financial statements.

Legal representation letters present legal counsel’s assessments of cases that are considered material to the financial statements either individually or in aggregate. Management schedules summarize those legal counsel assessments and indicate their effect on the financial statements. The representation letter and management schedule should corroborate the information in the financial statements.

Reporting Contingent Legal Liabilities on the Balance Sheet. The FY 2004 DoD Agency-Wide Balance Sheet included \$653 million of contingent legal liabilities in Other Liabilities based on \$344 million reported by the Army and \$309 million reported by the Air Force. As required by DoD 7000.14-R, DoD Financial Management Regulation, volume 6B, chapter 10, DoD and its Components disclose contingent liabilities (meeting the criteria for disclosure in the footnotes only) in Note 16 to the financial statements. Note 16 for the Army General Fund,² Air Force General Fund, and USACE included \$435 million, \$367 million, and \$4 billion in contingent legal liabilities, respectively. However, Note 16 to the DoD Agency-Wide Financial Statements did not include the information disclosed by the DoD Components.

¹ OMB Bulletin No. 01-02, “Audit Requirements for Federal Financial Statements,” amended July 27, 2004 and OMB Memoranda M-04-20, “FY 2004 Performance and Accountability Reports and Reporting Requirements for the Financial Report of the United States Government,” July 22, 2004.

² These reported amounts do not include contingent liabilities related to Chemical Material Demilitarization, Environmental Restoration, and Radioactive Waste Disposal, which were not included in the scope of the audit.

DoD Procedures for Compiling and Reporting Contingent Legal Liabilities

The DoD process for evaluating, estimating, and accounting for contingent legal liabilities is perfunctory and does not provide the means for auditors to corroborate or assess the impact of pending litigation, claims, and assessments represented on DoD financial statements. Specifically, DoD legal representations and management schedules do not corroborate financial presentation and disclosure on the Department's financial statements. The information contained in the legal letters and management schedules did not provide a basis for the DoD Agency-Wide, Army, Navy, Air Force, and USACE financial statement presentations.

We reviewed the evaluation, estimating, and accounting processes for the Army, Navy, Air Force, and USACE, as well as the information reported on the FY 2004 financial statements of these Components and the DoD Agency-Wide Financial Statements. Table 1 shows the inconsistencies across Components and the limitations of each process. Details of each DoD Component are subsequently discussed.

Table 1. Comparison of DoD Component Procedures for Reporting Contingent Legal Liabilities			
	Legal Opinions	Financial Presentation and Disclosure Supported?	Estimation Methodology Using Payout Averages?
Army	Limited to "Remote"	No	Yes
Navy	Limited to "Unable to express an opinion"	No	No
Air Force	All Classifications Used	Partially	Yes
USACE	Limited to "Remote"	No	No

Department of the Army. The Department of the Army legal representation process did not satisfy SFFAS and OMB reporting requirements. The process did not provide meaningful assessments of potential liabilities and was not linked to the Army process for reporting and disclosing contingent legal liabilities on the financial statements. The legal representation letters from the Army Office of General Counsel and the management schedule did not corroborate \$778.9 million accrued and disclosed as contingent legal liabilities in the FY 2004 Army financial statements, as shown in Table 2.

Table 2. Discrepancies Between FY 2004 Army Legal Representations and Financial Statements (in millions)			
Contingent Legal Liabilities	Legal Representation Letters	Financial Statement	Reported on the Financial Statements
“Probable”	\$0	\$344.0	An accrued liability
“Reasonably Possible”	\$0	<u>\$434.9</u>	Shown only in notes to the financial statements
		\$778.9	

Opinions on Legal Representation Letters Limited to “Remote.” The Army Office of General Counsel limited their opinions on the likelihood of unfavorable outcome for threatened or pending litigation to “remote” for all 77 cases reported with a claim amount totaling \$9.5 billion in FY 2004.³ Based on our review of the cases, we identified at least two cases (with a combined claim amount of \$123 million and estimated payouts totaling \$78.5 million) where it appeared that a loss was “reasonably possible.” One case indicated that an agreement in principle on a settlement had been reached, and the other case indicated an expectation of future monetary losses.

We did not question counsel for these specific cases because it was their policy to generally categorize all cases as “remote.” As the Army gets closer to receiving an audit opinion on its financial statements as a whole, we recognize that it will be the auditor’s responsibility to ensure clarification on the possibility of potential losses.

Financial Statement Presentation and Disclosure. The Army management schedule and legal representation letter did not corroborate \$778.9 million accrued and disclosed as contingent legal liabilities in its FY 2004 financial statements because Army financial managers utilized a data call process separate and distinct from the legal representation letters as the source for compiling contingent legal liabilities reported in financial statements. As part of the data call process, Army financial managers requested that Army legal counsel report the unsettled claim amount of all pending litigation, claims, and assessments categorized by the potential outflow of funds (“probable,” “reasonably possible,” and “remote”). Army legal counsel stated that it applied a historical payout ratio to current information to categorize the potential outflow of funds because each case is unique in nature and counsel has a difficult time forming an opinion on a case-by-case basis about the likelihood of an unfavorable outcome or monetary loss. However, the Army did not disclose the estimation methodology in its footnotes to the financial statements. Financial managers in

³ Army Office of General Counsel represented one case in its legal representation letter as “probable” but it was changed to “remote” on the management schedule, which was also prepared by Counsel.

the Office of the Assistant Secretary of the Army (Financial Management and Comptroller) did not review the Army Office of General Counsel's methodology for estimating amounts to be reported and disclosed in the financial statements. In addition, these financial managers did not reconcile and explain differences between legal representations and the financial statements because management relied solely on Army legal counsel for both.

Department of the Navy. The Department of the Navy legal representation process did not satisfy SFFAS and OMB reporting requirements. The process did not provide meaningful assessments of potential liabilities and did not corroborate disclosure on the FY 2004 Navy financial statements.

Opinions on Legal Representation Letters Limited to “Unable to Express an Opinion.” The Department of the Navy process did not provide meaningful assessments of the expected outcome of legal cases because legal counsel followed DoD Office of General Counsel direction and limited their evaluation results to “unable to express an opinion” for all contingent legal liability cases. Review of the information in the Navy legal representation letters for FY 2004 suggested that at least five cases valued at \$392.2 million could have been evaluated as at least “reasonably possible.” Information in the legal representation letter included language such as:

- “claim settled in 2001”
- “partial settlements reached”
- “parties have engaged in settlement discussions”
- “settlement discussions on-going”
- “ASBCA [Armed Service Board of Court Appeals] has decided entitlement on all claims”

We would not ordinarily question the conclusions of legal counsel. However, personnel from the Navy Office of General Counsel stated that it is their policy to not express an opinion concerning the likely outcome of cases except in very rare circumstances. Such a policy suggests that meaningful assessments *may not* be provided.

Financial Statement Presentation and Disclosure. The Navy Office of General Counsel represented that it was “unable to express an opinion” about the expected outcome of contingent legal liabilities with a total claim amount of \$305.7 billion. However, Note 16 to the Financial Statements for the Navy General Funds stated that the expected outcome of proceedings and legal actions, individually or in aggregate, would not have a material adverse effect on the Navy. Therefore, the information from the Navy legal representation letter contradicted information shown in the Navy financial statements.

Department of the Air Force. The Department of the Air Force employed evaluation and reporting processes that, in part, satisfied the intent of SFFAS and OMB reporting requirements. For example, the Air Force generally classified

contingent liability cases in accordance with SFFAS No. 5. In addition, it linked legal representation letters for cases assessed as “probable” with its process to calculate the contingent liabilities reported for claims and litigation from civil law. However, the Air Force did not fully substantiate amounts reported and disclosed on its FY 2004 financial statements.

Opinions on Legal Representation Letters Varied. Legal counsel for the Air Force stated that they tried to classify each contingent legal liability case in the proper category as either “probable,” “reasonably possible,” or “remote.” However, they acknowledged that sometimes they need to classify certain cases as “unable to express an opinion,” and 27 percent of the cases that the Air Force included on its FY 2004 legal representation letter fell into that category.

Financial Statement Presentation and Disclosure. The Air Force management schedule and legal representation letters did not fully substantiate the \$308.8 million accrued and \$367.3 million disclosed as contingent legal liabilities in its FY 2004 financial statements. The management schedule and legal letters did not disclose the estimation methodologies used to derive reportable liabilities. In addition, the management schedule did not reflect how legal letters for cases classified as “unable to express an opinion” were used to derive the liabilities reported in the Air Force financial statements. Also, our review disclosed:

- The Air Force accrued \$10.7 million as “probable” losses from contractor claims before the Armed Services Board of Contract Appeals based on FY 2003 data and disclosed \$115.6 million as “reasonably possible” losses based on total claims (instead of an estimation) for FY 2004. In FY 2003, it estimated \$11.5 million as possible losses from contractor claims by applying a multi-year historical payout rate to active cases.
- The Air Force used an Excel spreadsheet to calculate the \$284.5 million accrued as “probable” losses from claims and litigation and the \$246.0 million disclosed as “reasonably possible” losses. Although it recognized cases that individually were material and it applied a historical payout rate to all other cases, we identified some errors in the methodology used. Specifically,
 - Individual opinions shown in the spreadsheet for financial statement disposition sometimes differed from opinions stated on the legal representation letters (9 discrepancies out of 35 opinions), and the spreadsheet formulas did not capture all individual claims.
 - Accrued liabilities were based on total claim amounts instead of the estimated settlement value (provided on the legal representation letter) for individual cases classified as “probable.”
 - Amounts disclosed as possible liabilities were calculated using spreadsheet formulas that did not consider the estimated value or range of values (provided on the legal representation letter) for individual cases classified as “reasonably possible.”

Although the Air Force employed acceptable processes, it needs to review the methods used to estimate the contingent legal liabilities to assure accuracy and consistency. In addition, it needs to reconcile and explain differences between the legal letters, management schedule, and financial statements.

U.S. Army Corps of Engineers. The legal representation process used by USACE did not provide meaningful assessments of potential liabilities, and these assessments contradicted financial statement assertions.

Opinions on Legal Representation Letters Limited to “Remote.” It was USACE Office of the Chief Counsel’s policy to generally assess all cases as “remote.” For FY 2004, the total claim amount for cases exceeding the individual materiality threshold was \$3.3 billion. A review of the USACE legal representation letters suggested that at least seven cases with a claim amount of \$243 million *could* have been assessed as “reasonably possible.” Case facts included language such as:

- “a dispute remains over the amount that USACE must contribute”
- “contracting officer’s decision recognizes partial merit”
- “both parties are currently working towards a settlement”
- “negotiations have been ongoing”

We did not question legal counsel for these specific cases because it was their policy to generally categorize all cases as “remote.” As USACE gets closer to receiving an audit opinion on its financial statements as a whole, we recognize that it is will be the auditor’s responsibility to ensure clarification on the possibility of potential losses.

Financial Statement Presentation and Disclosure. USACE stated in its footnotes it was “reasonably possible” that 1201 claims valued at \$4 billion would result in a loss. (The \$3.3 billion discussed in the previous paragraph included only cases that exceeded the materiality threshold.) However, the USACE Office of the Chief Counsel told us that the footnotes should have stated that it was “remotely possible” that the claims would result in a loss. Neither statement was supported because USACE categorically represented cases as “remote” regardless of expected outcome.

DoD Agency-Wide Financial Statements. Note 16 to the FY 2004 DoD Agency-Wide Financial Statements did not include the contingent legal liabilities shown in the financial statements of the DoD Components previously discussed or disclose the amount of contingent legal liabilities for which legal counsel was unable to express an opinion. Note 16 to the FY 2004 DoD Agency-Wide Financial Statements merely stated that the expected outcome of matters involving pending or threatened litigation, claims, and assessments (individually or in the aggregate) would not have a material adverse effect on the Department. However, DoD had no basis for its assertion because it only provided opinions about the likelihood of an unfavorable outcome for \$1.45 billion of \$371.2 billion in claims (.4 percent) that were individually material to the DoD Agency-Wide

financial statements or to the Army, Navy, Air Force, and USACE financial statements. Therefore, the outcome was uncertain for 99.6 percent of those claims. The inability to express an opinion on such a large amount of claims represents a significant uncertainty about contingent legal liabilities that was material to the DoD Agency-Wide financial statements.

Aggregation of Cases

Legal representation letters and management schedules for DoD and its Components did not include immaterial cases that, in aggregate, exceeded the materiality thresholds requested by the auditors. As a result, DoD could not support its assertion in the DoD Agency-Wide financial statements that the aggregate of cases not included in the legal representation letters would not have an adverse impact on the financial statements.

The use of aggregation makes it easier for management (and its legal counsel) and auditors to perform their responsibilities and mitigate the risk of uncertainty regarding those cases that are not material and not presented individually on the legal representation letter.

Although we requested information on cases that, in aggregate, exceeded the specified materiality threshold, the legal representation letters and management schedules did not include that information. The request did not appear to be clearly understood by financial management and the legal counsels within DoD. We made the following observations about aggregation of individually immaterial cases:

- The Army Office of General Counsel did not provide information for claims valued at \$24.8 billion (72 percent of the value of total claims) because it aggregates only those cases that are factually similar.
- The Navy provided only minimum information on aggregated claims. The Navy Office of General Counsel stated that because the request from the Office of the Assistant Secretary of the Navy (Financial Management and Comptroller) was not clear, it defined aggregate to mean multiple cases or claims arising out of a single action, incident, or fatal circumstance that, in aggregate, exceeded the materiality threshold.
- The Air Force reported and disclosed aggregated information on its financial statements, but it did not discuss the information in its legal representation letter or document the financial statement disposition of aggregated amounts in its management schedule.
- USACE showed total claims of \$4 billion in Note 16 of its financial statements. However, its legal representation letters and management schedule only included potential contingent liabilities of \$3.3 billion—those cases that individually and in aggregate based on a single incident exceeded the materiality threshold.

OMB Bulletin No. 01-02, “Audit Requirements for Federal Financial Statements,” as amended July 27, 2004, requires auditors to work with management and agree on a materiality level for legal counsel to use in the legal representation letter. In the past we have used the guidelines in OMB Bulletin No. 01-02 or the GAO/President’s Council on Integrity and Efficiency Financial Audit Manual,⁴ based on the assumption that legal counsel would aggregate smaller cases that did not meet the reporting threshold for individual cases. Materiality levels are based, for example, on a percentage of assets and, therefore, do not correlate to the dollar value of the universe of claims or the distribution of those claims. As a result, there could be numerous small cases, regardless of similarities, that in aggregate could be material to the financial statements. However, our discussions with personnel from the DoD Office of General Counsel indicate that, in their opinion, only cases that are identical in almost every respect could be aggregated.

OMB Bulletin No. 01-02 does not specify how Federal agencies should aggregate cases and provide information in legal representation letters. It only provides, for illustrative purposes, that cases similar in nature should be aggregated where appropriate. Regardless of how aggregation is done, it should ensure that some type of representation is made concerning all claims that could be material to the financial statements as a whole. According to OMB, it is management’s responsibility to determine how information is aggregated and reported to the auditors. The GAO/President’s Council on Integrity and Efficiency Financial Audit Manual suggests that cases not included individually or as part of a group of similar cases should be aggregated to determine whether they would be material to the financial statements taken as a whole.

There is no requirement to aggregate cases as long as auditors are able to determine the magnitude of potential legal claims. We have suggested that management and legal counsel aggregate cases to reduce the amount of work required to support an audit opinion. If management (and legal counsel) is unable to establish procedures for providing aggregate information about contingent legal liabilities, auditors would need to set the individual materiality level low enough to provide assurance that claims not included in the legal representation letter would not be material to the financial statements. As a result, counsel may have to provide legal representations individually for an even greater number of cases.

We support the use of estimation methodologies similar to those used by the Army and the Air Force for presenting possible losses based on historical data, if considered appropriate. However, use of such estimation methodologies is not mandatory.

⁴ GAO uses .025 percent of the materiality base for individual cases for the U.S. Government Consolidated Financial Statements as discussed in the GAO Financial Audit Manual. OMB Bulletin No. 01-02 *suggests* setting the materiality level for the legal letter at .015 percent of the audit materiality base. (These two percentages were calculated based on suggested criteria in the Financial Audit Manual for determining auditing planning and design materiality.) These low levels of materiality were designed to capture contingent liabilities that could possibly have an effect on the financial statements. However, as shown in the audit, our use of the reporting thresholds used by GAO for the FY 2004 financial statement audit did not, for example, include \$24.7 billion in smaller claims for cases that, individually, did not meet the reporting threshold we requested.

Process Ownership and Direction

DoD has not adopted policies and procedures to assure that it consistently evaluates, estimates, and accounts for litigation, claims, and assessments as a basis for the preparation of financial statements to comply with Federal financial accounting standards. DoD management has not taken ownership of the process; instead it relies solely on legal counsel for reporting contingent legal liabilities in the financial statements. Other Federal agencies receiving audits of their financial statements were able to provide the required information to satisfy auditing standards.

SFFAS Guidance versus American Bar Association Policy Statement. DoD representations are limited because DoD financial managers have generally relied solely on legal counsel for reporting contingent legal liabilities while counsel evaluates the likelihood of an unfavorable outcome based on the American Bar Association (ABA) “Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information.” Strict adherence to ABA policy has caused DoD to limit its representations. The basic premise of the ABA Policy Statement is that legal counsel will provide an opinion on the likelihood of loss only if they are quite certain no loss will occur or that a loss will occur that can be easily quantified. (See Appendix C for a more detailed discussion and comparison of the guidelines of the ABA and SFFAS No. 5, and how legal counsel within DoD has interpreted this guidance.)

DoD Management Responsibility. It is DoD management’s responsibility to adopt policies and procedures to evaluate, estimate, and account for litigation, claims, and assessments as a basis for the preparation of financial statements in conformity with Federal financial accounting standards. Counsel within DoD, as part of management, needs to be part of the process. The GAO/President’s Council on Integrity and Efficiency Financial Audit Manual, April 2003, states that while management often relies on the advice of legal counsel about the likelihood of an unfavorable outcome and estimates of the amount or range of potential loss, management is ultimately responsible for determining whether these legal loss contingencies are “probable,” “reasonably possible,” or “remote.” As explained in Appendix C, DoD financial managers have deferred the process of reporting contingent legal liabilities to Component legal counsels and have not provided effective oversight necessary to assure that losses from contingent legal liabilities are accurately classified and disclosed in the financial statements. DoD needs to synchronize its processes for the legal representation letters, data call and estimation, aggregation, management schedules, and financial statement disposition so it can provide meaningful and substantiated assertions on its financial statements.

DoD Consistency with Reporting by Other Federal Agencies. GAO audits the Consolidated Financial Statements of the Federal Government. GAO has expressed concerns about DoD assessments of contingent legal liabilities and the representations made on the DoD Agency-Wide financial statements. GAO stated

that the DoD use of “unable to express an opinion” represents the exception within the Federal Government. In an effort to gain insight into the legal representation process of other Federal agencies, we corresponded with auditors of eight Federal agencies.

Auditors from six of the eight Federal agencies stated that they did not receive opinions such as “unable to express an opinion” on contingent legal liability outcomes. Only one agency representative stated that general counsel categorically limited opinions because of concerns about public access to legal representation letters under the Freedom of Information Act. However, the auditors held discussions with personnel from the Office of the Chief Financial Officer and General Counsel to address their concerns so that the security of those representations would not be compromised.

DoD management needs to identify and mitigate the concerns of the DoD Office of General Counsel and general counsels in the Military Departments, Defense agencies, and other DoD Component reporting entities with regard to expressing and sharing legal opinions. Further, DoD management needs to develop solutions that enable legal counsel to classify the likelihood of an unfavorable outcome under one of the three classifications as defined by SFFAS No. 5, and provide counsel direction in estimating the amount or range of potential loss. Because counsel has concerns, it is the responsibility of DoD management to mitigate those concerns to develop a solution amicable to all parties so that DoD satisfies Federal financial accounting and reporting requirements.

FY 2005 Interim Legal Representation Letters. Our audit focused on the legal representation letters and support for information in the FY 2004 financial statements for DoD and its major Components. At the conclusion of our field work in August 2005, we noted that information in the interim legal representation letters and management schedules for the FY 2005 audit had not changed significantly from information we reviewed supporting the FY 2004 financial statements with one exception. The legal representation letter for the Army showed “remote” for most cases. However, the legal representation letter for the DoD Agency-Wide financial statements showed “unable to express an opinion” for many of the same cases. Different conclusions for the same cases cast additional doubt on the integrity of the process.

Conclusion

Financial statement assertions made in the FY 2004 Financial Statements by DoD and its major Components about contingent legal liabilities were not supported because DoD was unable to provide assessments individually or in aggregate about the expected outcome of matters involving pending or threatened litigation. Also, DoD financial statements usually did not disclose significant uncertainty based on the information in the legal representation letters. In addition, DoD Components were not consistent in how they accrued and disclosed contingent legal liabilities. The Departments of the Army and Air Force used estimation methodologies that were not disclosed in their legal representation letters and management schedules. The Department of the Navy and USACE did not apply estimation methodologies.

Without meaningful evaluations, as prescribed in SFFAS No. 5, auditors cannot make determinations about the fairness of the representation and disclosure on the financial statements or that the expected outcome of litigation will not materially affect the financial statements. If not corrected, DoD's inability to substantiate financial statement presentations may preclude a favorable opinion on future DoD financial statements and perhaps those of the Federal Government.

Management Comments on the Finding and Audit Response

The Deputy Chief Financial Officer, Deputy General Counsel (Fiscal), and Assistant Secretary of the Navy (Financial Management and Comptroller) provided the following comments on the finding. For the full text of their comments, see the Management Comments section of the report.

Office of Under Secretary of Defense (Comptroller) Comments. The Deputy Chief Financial Officer disagreed that the Department's process for evaluating, estimating, and accounting for contingent legal liabilities is perfunctory. She stated that her office works closely with the DoD Office of General Counsel to prepare the summary schedule of reported cases and to ensure proper reporting of legal contingencies.

DoD Office of General Counsel Comments. The Deputy General Counsel (Fiscal) stated that there was absolutely no basis for the statement that the DoD process for evaluating, estimating, and accounting for contingent legal liabilities is perfunctory. He stated that the DoD Office of General Counsel and each of the Offices of General Counsel of the Army, Navy, and Air Force expend considerable time and effort to ensure that the information reported in legal representation letters is complete, thorough, and accurate. He stated that the report ignored the fact that the Department's method of reporting cases and the practice of generally declining to express an opinion concerning outcomes and limits of liability is consistent with ABA standards. Further, the report did not acknowledge the direct relationship between ABA standards and a lawyer's professional and ethical obligations toward the lawyer's client. He noted that, while rare, the Department has consistently expressed opinions concerning case outcomes when case facts support such an opinion.

The Deputy General Counsel (Fiscal) stated that his office adheres to the concept that cases should only be aggregated when cases and the underlying principles are clearly identical. This concept is consistent with reporting cases "at or above" the materiality threshold. To aggregate cases below the materiality threshold until such threshold is reached would mandate collecting and reporting information concerning every case or controversy against the Department. He stated that his office does not agree that immaterial cases can be made material simply by aggregating. In the opinion of his office, the aggregation of smaller cases is not required and is not supportable by either OMB Bulletin No. 01-02 or the GAO/President's Council on Integrity and Efficiency Financial Audit Manual. Further, OMB Bulletin No. 01-02 reference to "[c]ases similar in nature should be aggregated where appropriate" is a shorthand encapsulation of the conditions that must be met before individual cases can be certified as a class action. The

conditions that must exist to certify a class action lawsuit are that the plaintiffs are similarly situated and the defendants, basic facts, and legal issues are the same.

The Deputy General Counsel (Fiscal) included a 152-page attachment⁵ in his response which discussed analysis by his office of information contained in contingency footnotes to 23 Chief Financial Officers Act agencies', Department of Homeland Security, and U.S. Government-wide FY 2004 financial statements. He stated that, after reviewing this information, it is hard to ascertain any single method for reporting cases or expressing an opinion concerning their outcome or anticipated amount of liability. Further, how claims and contingencies are reported does not seem to affect whether an agency receives an unqualified audit opinion.

Navy Comments. The Assistant Secretary of the Navy (Financial Management and Comptroller) stated that expressions concerning case outcomes and potential liabilities made by the Department of the Navy have been consistent with the facts of the cases being reported, the realities of litigation, and the ABA guidelines concerning such reports. Further, they are in strict conformance with specific guidance from the DoD Office of General Counsel. Therefore, they are consistent with the overarching generally accepted accounting principle that financial statements must fairly and accurately present the financial status and other facts pertaining to the reporting agency.

Audit Response. We recognize the efforts of DoD and its Component personnel in compiling information about its contingent legal liabilities. However, the process for evaluating, estimating, and accounting for contingent legal liabilities produced legal representations and management schedules that did not corroborate financial statement assertions. As depicted in Appendix C, DoD believes that it is limited in what it can conclude, document, and provide to auditors. DoD Components told us that they categorically classified individual cases, regardless of case facts. DoD has, in effect, taken the position that only those contingent legal liabilities meeting the definition of a liability should be reported or disclosed. As such, the process derived does not satisfy the intent of the accounting standards; therefore, the financial statements do not present the relevant information intended by SFFAS No. 5, as amended. As shown in the report, DoD and its major Components need to synchronize their processes for legal representation letters and management schedules with their processes for reporting and disclosing contingent legal liabilities in conformity with SFFAS No. 5, as amended. Further, their processes should result in information that provides the means for auditors to corroborate or assess financial statement assertions and the impact of pending litigation, claims, and assessments on DoD financial statements.

We recognize the professional and ethical obligations of DoD and its Component legal counsel to preserve client confidences, as well as attorney-client privileged communications under applicable law. In addition, we recognize that counsel must adhere to the ABA "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information." Appendix C of the report discusses legal

⁵ The attachment has been omitted from this report because of its length. Copies will be provided upon request.

guidelines and illustrates the differences between legal and accounting guidelines. Further, it discusses the underlying principles specified by counsel for legal opinions expressed on legal representation letters. The appendix is intended to convey, in part, the concerns of counsel with regard to expressing and sharing legal opinions and to demonstrate the need for financial management, with involvement by counsel, to develop solutions amicable to all parties so that DoD and its major Components consistently evaluate, estimate, and account for pending litigation, claims, and assessments as a basis for financial statement presentation and disclosure in conformity with SFFAS No. 5, as amended.

The Deputy General Counsel (Fiscal) is correct that immaterial cases are not made material simply by aggregating them. More specifically, they are not necessarily material to the financial statements, taken as a whole. Our discussion regarding aggregation of cases is intended to convey that information on smaller cases, individually or in aggregate, is needed to determine the magnitude of potential legal claims. The GAO/President's Council on Integrity and Efficiency Financial Audit Manual states that:

In aggregating cases, the auditor and the entity may use two levels of aggregation. First, similar cases (such as employment discrimination cases . . . or military promotion board challenges) should be aggregated and treated as a group and compared with the individual materiality level. The aggregation generally should include a list of the individual cases that are aggregated and a discussion of the items of information requested to be included in the legal letter. . . . Second, all cases not included in the legal letter individually or as part of a group of similar cases should be aggregated. . . .

In determining a materiality level for the legal letter, the auditor should set the level sufficiently low [to provide assurance] that the cases not included in the legal letter would not be material to the financial statements taken as a whole when aggregated with (1) other cases not included in the letter, (2) all other types of contingencies, (3) all other items that would not be adjusted because they are judged immaterial (unadjusted misstatements), (4) all other amounts in the financial statements that would not be tested directly because they were judged to be immaterial, and (5) all other items resolved on the basis of materiality considerations. . . .

Therefore, regardless of how aggregation is done, it should ensure that some type of representation is made concerning all legal claims that could be material to the financial statements as a whole.

We recognize that OMB guidance is vague and that clarity needs to be provided. As stated in the report, OMB Bulletin No. 01-02 does not specify how Federal agencies should aggregate cases and provide information in legal representation letters. Instead, OMB Bulletin No. 01-02 provides an illustrative letter of inquiry from agency management to legal counsel that states “[c]ases similar in nature should be aggregated where appropriate.” It also provides a format for the management schedule that instructs Chief Financial Officers to “work with legal counsel to provide further disaggregation of dissimilar cases.” Further, “CFOs

[Chief Financial Officers] should use professional judgment, considering the purpose of this schedule when determining the level of aggregation.”

We have discussed possible revisions with OMB so that OMB Bulletin No. 01-02 better reflects auditor information needs as described in the GAO/President’s Council on Integrity and Efficiency Financial Audit Manual. However, until revisions are made and implemented, we reiterate that financial management, with involvement by counsel, needs to develop solutions for aggregating cases amicable to all parties so that DoD and its major Components provide, as part of the legal representation letter and management schedule process taken together, the means for auditors to corroborate or assess financial statement assertions and the impact of pending litigation, claims, and assessments on DoD financial statements.

The extensive amount of additional information provided in the Deputy General Counsel (Fiscal) response, which related to the footnotes for contingent liabilities of other Federal reporting entities, does not provide for the relevant information supporting these footnotes. Specifically, it does not describe the nature and extent of evidential matter provided to auditors which may have helped them to assess management’s assertions concerning the effect of legal loss contingencies on the financial statements for purposes of rendering an audit opinion. Auditing standards require auditors to obtain sufficient competent evidential matter from management, supported by legal counsel, regarding pending or threatened litigation and unasserted claims and assessments to support management’s assertions in financial statements. If we are unable to obtain satisfactory information on the nature and extent of legal loss contingencies through the legal representations process, we may not be able to provide a favorable audit opinion on future DoD financial statements. Because DoD is a material component of the consolidated financial statements of the U.S. Government, our opinion may affect the audit opinion given on the Government statements.

Although the Navy endeavored to follow ABA guidelines and guidance from the DoD General Counsel, we do not believe that the Navy was fully satisfying SFFAS No. 5, as amended, which is the generally accepted accounting principle relevant to accounting for and reporting contingent legal liabilities of the Federal government. The Navy relied solely on the legal representation process as the basis for reporting and disclosing contingent legal liabilities in Navy financial statements. Therefore, the Navy only considered legal claims that individually or in aggregate as part of a group of similar cases met materiality thresholds established by auditors (not accountants). In addition, it did not consider information on cases not included in the legal representation letter individually or in aggregate. Further, it substituted concepts of probability specified for the accounting profession in SFFAS No. 5, as amended, with concepts of probability specified for the legal profession *in ABA guidelines for furnishing information to auditors*. As a result, the Navy did not fully consider the magnitude of potential legal claims in making accrual and disclosure determinations for contingent legal liabilities.

Recommendations, Management Comments, and Audit Response

Revised Recommendation. Based on management comments and because the Chief Financial Officer is responsible for ensuring that Federal financial accounting standards are followed, we have revised the recommendation to make the Under Secretary of Defense (Comptroller)/Chief Financial Officer the lead for implementing Recommendation 1.

1. We recommend that the Under Secretary of Defense (Comptroller)/Chief Financial Officer take the lead in working with the DoD Office of General Counsel to establish a forum or other vehicle, with representation from the management and legal counsels from each of the DoD reporting entities, to mitigate the concerns of counsel. Specifically,

a. Develop solutions for providing meaningful assessments based on the requirements of the Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," as amended, and Office of Management and Budget Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," amended July 27, 2004.

Office of Under Secretary of Defense (Comptroller) Comments. The Deputy Chief Financial Officer partially concurred, stating that her office has noticed inconsistent reporting across the Federal Government. She stated that her office would work with the Office of Management and Budget and the Department of Treasury to ensure standardized reporting across the Government, which could then be implemented across DoD.

DoD Office of General Counsel Comments. The Deputy General Counsel (Fiscal) partially concurred, stating that, from his office's review of footnotes for the FY 2004 Chief Financial Officer Act agencies', Department of Homeland Security, and Government-wide financial statements, the recommended actions should be elevated for Government-wide consideration. Otherwise, the proliferation of different approaches, none of which seems to preclude other auditors from rendering an unqualified opinion, will continue. The Deputy General Counsel (Fiscal) also stated that his office does not concur with any suggestion that the current process for reporting contingent legal liabilities is not fully compliant with the requirements.

Navy Comments. Although not required to comment, the Assistant Secretary of the Navy (Financial Management and Comptroller) stated that the DoD cannot simply ignore or disregard the American Bar Association's "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information." DoD has included a category "Unable to Express an Opinion Concerning the Likely Outcome of this Case" for reporting cases in connection with an auditor's review of financial statements, which is consistent with both the Statement of Policy and the reality of litigation.

Audit Response. Comments by the Deputy Chief Financial Officer and Deputy General Counsel (Fiscal) are not responsive. The Deputies appeared to be more interested in standardized reporting across the Federal Government than in addressing the issues identified by the report that are specific to DoD. Although we support discussions to ensure a more consistent and standardized Government-wide reporting of contingent legal liabilities, there is no evidence to suggest that the concerns conveyed by DoD and its major Component legal counsels with regard to expressing and sharing legal opinions is a Government-wide issue. The recommendation was based on trends we observed in the legal representation letters and the explanations for those trends. As stated in Appendix C, the Army and U.S. Army Corps of Engineers told us that they limited opinions on likely outcome to “remote,” regardless of case facts or anticipated outcome, so that its legal positions would not be revealed outside attorney-client channels. The DoD Office of General Counsel and Navy told us that, consistent with American Bar Association guidelines, it is their policy to not express an opinion concerning the likely outcome of cases except in very rare circumstances. Financial managers need to work with legal counsel to mitigate the concerns of counsel and make certain legal representation letters reflect meaningful assessments of case facts. Further, financial managers need to assess cases in which legal counsel was “unable to express an opinion” as to the likelihood of loss to determine whether those legal uncertainties, individually or in aggregate, have a material affect on the financial statements and should be disclosed. Its decisions on how such information will be reported and disclosed should be shown in its management schedule.

Financial managers are ultimately responsible for classifying legal loss contingencies under one of the three classifications as defined by Statement of Federal Financial Accounting Standards No. 5, as amended, and making financial accounting and reporting determinations for contingent legal liabilities. Our responsibility is to follow auditing standards and evaluate whether the guidance shown in the accounting standards are followed. We are making a minor revision to the recommendation to emphasize that the Under Secretary of Defense (Comptroller)/Chief Financial Officer should take the lead for implementing Recommendation 1. The Chief Financial Officer has the responsibility to ensure that DoD follows Federal financial accounting standards. We request that the Under Secretary provide comments in response to the final report.

b. Develop and implement a uniform methodology for estimating, aggregating, and reporting contingent legal liabilities.

Office of Under Secretary of Defense (Comptroller) and DoD Office of General Counsel Comments. The Deputy Chief Financial Officer and Deputy General Counsel (Fiscal) stated that it was unclear whether the recommendation referred to a financial reporting definition of aggregation or a legal definition. The Deputy Chief Financial Officer concurred if the recommendation referred to a financial reporting definition of aggregation, stating that her office would comply. The Deputy General Counsel (Fiscal) deferred to the Office of the Under Secretary of Defense (Comptroller) if the recommendation referred to a financial reporting definition of aggregation. However, if it referred to a legal definition, his office nonconcurred, stating that the procedures, principles, and guidelines followed by the General Counsel of the DoD and the Military Departments for the

collection and reporting of cases is compliant with all standards applicable to a lawyer's professional responsibilities and duties. He added that in view of the inherent uncertainties applicable to cases, any estimates of legal liabilities would be speculative and would do nothing to advance the goal of having fair and accurate financial statements.

Navy Comments. Although not required to comment, the Assistant Secretary of the Navy (Financial Management and Comptroller) stated that it is critical that the Office of the Secretary of Defense establish a uniform methodology for the aggregation of cases and provide each of the military services a legal definition that will be used to aggregate the cases, where applicable. He stated that the DoD Office of the Inspector General has not developed a clear definition of aggregation. In its memorandum calling for legal representation letters, the Inspector General mentioned aggregation only once stating that "[c]ases similar in nature should be aggregated where appropriate." Thus, the Department of the Navy instructed its activities to aggregate claims arising out of a single event (litigation, claim, or assessment) or series of events and to report aggregate claims that meet the Inspector General's materiality threshold.

The Assistant Secretary of the Navy (Financial Management and Comptroller) also stated that cases reported in the legal representation letters have an associated amount; therefore, there is no need for the Office of the Secretary of Defense to develop a uniform estimating methodology. Further, the Office of the Secretary of Defense has developed a uniform methodology for reporting contingent legal liabilities, and it is in compliance with the American Bar Association's Statement of Policy.

Audit Response. Comments by the Deputy Chief Financial Officer and Deputy General Counsel (Fiscal) are not responsive. It is not clear whether the Deputies plan to establish a forum or other vehicle, with representation from the management and legal counsels from each of the DoD reporting entities, to solve the specific problems within DoD. We request that the Under Secretary of Defense (Comptroller)/Chief Financial Officer provide comments to the final report that address how DoD will develop and implement a uniform methodology for estimating, aggregating, and reporting contingent legal liabilities.

The recommendation relates to our discussion regarding aggregation of cases, which was primarily based on the guidance shown in the Government Accountability Office/President's Council on Integrity and Efficiency Financial Audit Manual. It was intended to convey that information on smaller cases not included in the legal representation letter, individually or in aggregate, is needed to determine the magnitude of potential legal claims. Further, such information should be requested, collected, and shown in a management schedule. We recognize that Office of Management and Budget Bulletin No. 01-02 could provide better clarification regarding aggregation, and we are awaiting the Office of Management and Budget to revise this regulation based on our input and the input of the Government Accountability Office.

Regarding the unsolicited comments from the Navy concerning a uniform methodology for estimating and reporting contingent legal liabilities, we were unable to identify anything that was uniform within DoD, as illustrated in Table 1

and throughout the report. We advocate uniformity and consistency in whatever methods are utilized to quantify and report legal loss contingencies considered probable or reasonably possible. The Navy states that the Office of the Secretary of Defense methodology for reporting contingent legal liabilities is in compliance with the American Bar Association's Policy Statement. But what continues to be missing is an assessment of compliance when measured against Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," as amended.

2. We recommend that the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer publish policy in the DoD Financial Management Regulation 7000.14-R to ensure DoD and its Components consistently apply accounting and auditing standards cited in 1.a. and consistently disclose all contingent liabilities considered to be material to the financial statements.

Office of Under Secretary of Defense (Comptroller) Comments. The Deputy Chief Financial Officer partially concurred, citing her response to Recommendation 1.a. She stated that, upon followup discussions with the DoD Components, Office of General Counsel, other Federal agencies, Office of Management and Budget, and Department of Treasury, her office would revise the DoD Financial Management Regulation, as appropriate.

DoD Office of General Counsel and Navy Comments. Although not required to comment, the Deputy General Counsel (Fiscal) reiterated his comments to Recommendation 1.a. and stated that his office believes that the Department fully complies with Office of Management and Budget Bulletin No. 01-02. The Assistant Secretary of the Navy (Financial Management and Comptroller) nonconcurred with the recommendation to the extent that it suggested that DoD ignore the American Bar Association's "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information."

Audit Response. The Deputy Chief Financial Officer comments are partially responsive. Based on the comments to Recommendation 1.a., it is not clear whether the Deputy plans to address and solve the specific problems within DoD. Management should realize that accounting standards referenced in the recommendation are not established by the Office of General Counsel and other Federal Chief Financial Officer reporting agencies. Federal financial accounting standards are established by the Federal Accounting Standards Advisory Board. Although we consider its comments partially responsive, we have decided not to request additional comments to the final report. We will await the revisions to the DoD Financial Management Regulation to fully evaluate DoD's responsiveness.

Regarding the unsolicited comments from the Navy, we want to clarify that we are not suggesting in any way that DoD (and its lawyers) ignore American Bar Association standards. It is the policy of the DoD Office of the Inspector General to follow auditing standards established in the Government Accountability Office/President's Council on Integrity and Efficiency Financial Audit Manual and Office of Management and Budget Bulletin No. 01-02. It is our hope that the new version of Office of Management and Budget Bulletin No. 01-02 will clarify ambiguities regarding the intent and goals of aggregation, responsibilities in

relation to legal letters, management schedules, and compliance with accounting standards taken together, and the underlying purpose of the legal representation process.

3. We recommend that the Under Secretary of Defense (Comptroller)/Chief Financial Officer, Office of the Assistant Secretary of the Army (Financial Management and Comptroller), Office of the Assistant Secretary of the Navy (Financial Management and Comptroller), Office of the Assistant Secretary of the Air Force (Financial Management and Comptroller), and the Commander, U.S. Army Corps of Engineers:

- a. Ensure that amounts accrued in “Other Liabilities” and information disclosed for contingent liabilities in Note 16 to the financial statements is fully supported and agrees with information in the legal representation letters and management schedule.**

Office of Under Secretary of Defense (Comptroller) Comments. The Deputy Chief Financial Officer concurred, stating that her office would ensure that information in financial statements is supportable and agrees with information in legal letters and management schedule.

Army Comments. The Deputy Assistant Secretary of the Army (Financial Operations) concurred, stating that his office will coordinate with the Office of the Army General Counsel to ensure information provided for financial reporting has required support and audit trails. Further, his office will assess whether amounts accrued and disclosed agree with the legal representation letters, where applicable. However, he stated that future note disclosures may differ from legal representation letter information due to document preparation considerations that apply. For example, the legal representation letter must be prepared using agreed-upon reporting thresholds while Note 16 is not compiled with such parameters.

Navy Comments. The Assistant Secretary of the Navy (Financial Management and Comptroller) concurred, stating that the Department of the Navy already does this.

Air Force Comments. The Deputy Assistant Secretary of the Air Force (Financial Operations) concurred, stating that financial management personnel will ensure legal representation letters and the management schedule fully substantiate amounts reported and disclosed as contingent legal liabilities on its financial statements. Further, financial management personnel will continue to work with legal counsel to ensure that differences between the legal letters, management schedule, and financial statements are reconciled and explained.

U.S. Army Corps of Engineers Comments. The Commander, U.S. Army Corps of Engineers, concurred, generally reiterating the recommended actions and stating that the Resource Management Directorate will work with the Office of Counsel to complete the actions.

DoD Office of General Counsel Comments. Although not required to comment, the Deputy General Counsel (Fiscal) concurred that the contingencies

footnote should reflect the information contained in the legal representation letters; however, he stated that his office does not believe that all the information in that footnote must be included in the legal representation letters. He indicated that other information not related to the information contained in the legal representation letter could be disclosed in the footnote as long as the basis on which it is being reported is clearly identified and distinguished from legal letter information.

Audit Response. Comments by the Deputy Chief Financial Officer, Deputy Assistant Secretary of the Army (Financial Operations), Deputy Assistant Secretary of the Air Force (Financial Operations), and Commander, U.S. Army Corps of Engineers, are responsive. Although the Assistant Secretary of the Navy (Financial Management and Comptroller) concurred, we do not consider its comments responsive. As stated in the report, Navy legal representations contradicted its assertions in Note 16 to the financial statements. Also, auditing standards require auditors to consider the completeness assertion embodied in the account balance, transaction class, and disclosure components of the financial statements. Because the Navy relied solely on the legal representation process as the basis for reporting and disclosing contingent legal liabilities in Navy financial statements, we do not believe that the Navy fully considered the magnitude of potential legal claims in making accrual and disclosure determinations. However, because we plan to revisit the report subject during our annual audits of the financial statements for DoD and its major Components, we have decided not to request additional comments from the Navy. We will continue to work with the Navy to ensure contingent legal liabilities are appropriately reported and disclosed in the financial statements.

b. Review and approve estimation methodologies and disclose, when applicable, those methodologies in Note 16 of the financial statements.

Office of Under Secretary of Defense (Comptroller) Comments. The Deputy Chief Financial Officer concurred, stating that her office would review, approve, and disclose estimating methodologies in financial statements, as appropriate.

Army Comments. The Deputy Assistant Secretary of the Army (Financial Operations) concurred, generally reiterating the recommended actions and stating that his office will coordinate with the Office of the Army General Counsel to complete the actions. Further, approval of estimation methodologies will be contingent upon Office of the Army General Counsel adherence to applicable regulation and guidance for compiling contingent liabilities for financial reporting.

Navy Comments. The Assistant Secretary of the Navy (Financial Management and Comptroller) nonconcurred, stating that estimating methodologies only add complexity and questions. Further, the Assistant Secretary indicated that there is nothing to suggest that generally accepted accounting principles require any single method for reporting cases or the expression of an opinion concerning the outcome or anticipated amount of liability with respect to the cases. He indicated that, based on a lack of uniformity in reporting methodology found in a review of other Chief Financial Officer Act agencies' financial statements, there is no single principle set forth by generally accepted accounting principles for whether case

outcome and potential loss need to be expressed in financial statement footnotes. Further, this lack of a single principle did not seem to affect whether the agencies' statements achieved an unqualified audit opinion.

Air Force Comments. The Deputy Assistant Secretary of the Air Force (Financial Operations) concurred, stating that financial management personnel will review the methods used to estimate contingent legal liabilities to ensure those methods accurately and consistently calculate contingent legal liabilities. Further, personnel will disclose the estimation methods in Note 16, "Commitments and Contingencies," when applicable. He also stated that his office will work with legal counsel to ensure the management schedule and legal representation letters disclose the estimation methods.

U.S. Army Corps of Engineers Comments. The Commander, U.S. Army Corps of Engineers, concurred, generally reiterating the recommended actions and stating that the Resource Management Directorate will work with the Office of Counsel to complete the actions. Further, approval of estimation methodologies would be contingent upon the Corps Office of Counsel adherence to applicable regulation and guidance for compiling contingent liabilities for financial reporting.

DoD Office of General Counsel Comments. Although not required to comment, the Deputy General Counsel (Fiscal) questioned the utility of any information developed from an estimation methodology. In view of the inherent uncertainties of all litigation, projecting past results onto current facts would appear to be highly speculative. However, he stated that his office did not believe there would be any obstacle to presenting such information in the footnote as long as it was made clear that the information was derived from accounting or statistical methods and was not based on any evaluation by an attorney concerning the outcome of any pending cases.

Audit Response. Comments by the Deputy Chief Financial Officer, Deputy Assistant Secretary of the Army (Financial Operations), Deputy Assistant Secretary of the Air Force (Financial Operations), and Commander, U.S. Army Corps of Engineers, are responsive. Comments by the Assistant Secretary of the Navy (Financial Management and Comptroller) are not responsive. We did not recommend that the Navy develop estimating methodologies. Our recommendation was intended to convey, in part, that if the Navy uses estimation methodologies to derive contingent legal liabilities reported and disclosed on its financial statements, the Office of the Assistant Secretary of the Navy (Financial Management and Comptroller) should *review and approve* those methodologies. As stated in the report, we support the use of estimation methodologies similar to those used by the Army and the Air Force for presenting possible losses based on historical data, if considered appropriate. However, use of such estimation methodologies is not mandatory. Because we plan to revisit the report subject during our annual audits of the financial statements for DoD and its major Components, we have decided not to request additional comments from the Navy.

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- c. **Disclose in Note 16 to the financial statements the dollar value of claims that legal counsel is unable to express an opinion or unable to provide an estimate or range of estimates for contingent legal liabilities, if such contingent liabilities are material to the financial statements.**

Office of Under Secretary of Defense (Comptroller) Comments. The Deputy Chief Financial Officer partially concurred, citing her response to Recommendation 1.a. She stated that, upon followup discussions with the DoD Components, Office of General Counsel, other Federal agencies, Office of Management and Budget, and Department of Treasury, her office would disclose, if appropriate, the dollar value of claims that legal counsel is unable to express an opinion if such contingent liabilities are material to the financial statements.

Army Comments. The Deputy Assistant Secretary of the Army (Financial Operations) partially concurred, stating that his office will coordinate with the Office of the Army General Counsel to gather and assess the dollar value of claims that legal counsel is unable to express an opinion or unable to provide an estimate or range of estimates. However, he stated that disclosure of this information will not be limited to materiality thresholds and will take in to account the many complexities of assessing claims.

Navy Comments. The Assistant Secretary of the Navy (Financial Management and Comptroller) nonconcurred, stating that the manner of reporting cases must fairly and accurately present the agency's financial status and is at management's discretion. Further, each and every case and situation needs to be evaluated in the context of its unique situation. Where opinions are made, the opinions should be factually and logically supportable.

Air Force Comments. The Deputy Assistant Secretary of the Air Force (Financial Operations) nonconcurred, stating that, as noted in the report, the Air Force employs evaluation and reporting processes that satisfy the intent of reporting requirements. However, he stated that if legal counsel is unable to classify a claim as "probable," "reasonably possible," or "remote," and no other evaluation and reporting process is used, it is understandable to disclose the dollar value of claims in Note 16.

U.S. Army Corps of Engineers Comments. The Commander, U.S. Army Corps of Engineers, concurred, stating that the Resource Management Directorate will work with the Office of Counsel to gather and assess the dollar value of claims that legal counsel is unable to express an opinion or unable to provide an estimate or range of estimates.

DoD Office of General Counsel Comments. Although not required to comment, the Deputy General Counsel (Fiscal) stated that there is no legal objection to presenting this information; however, he questioned its utility. He restated that his office did not believe there would be any obstacle to presenting such information in the footnote as long as it was made clear that the information was derived from accounting or statistical methods and was not based on any evaluation by an attorney concerning the outcome of any pending cases.

Audit Response. Comments by the Deputy Assistant Secretary of the Army (Financial Operations) and Commander, U.S. Army Corps of Engineers, are responsive. Although the Deputy Assistant Secretary of the Air Force (Financial Operations) nonconcurred, we consider its comments responsive because the Air Force employs an evaluation methodology and reporting process that satisfies the intent of the reporting requirements. Comments by the Deputy Chief Financial Officer are partially responsive and comments by the Assistant Secretary of the Navy (Financial Management and Comptroller) are not responsive. Our recommendation was intended to convey, in part, that financial managers need to request, collect, and assess cases in which legal counsel was “unable to express an opinion” as to the likelihood of loss to determine whether those legal uncertainties, individually or in aggregate, have a material affect on the financial statements and should be disclosed. It is not clear whether the Office of the Under Secretary of Defense (Comptroller) or the Navy will make such a determination. However, because we plan to revisit the report subject during our annual audits of the financial statements for DoD and its major Components, we have decided not to request additional comments from DoD or the Navy. We will continue to work with DoD and the Navy to ensure contingent legal liabilities are appropriately disclosed in the financial statements.

Appendix A. Scope and Methodology

We selected the DoD Agency-Wide and major Components required by OMB to receive audit opinions on their FY 2004 financial statements, which received disclaimers of audit opinion. The Components are the Army General and Working Capital Funds, Navy General and Working Capital Funds, Air Force General and Working Capital Funds, and the U.S. Army Corps of Engineers Civil Works Program. The Components reported contingent liabilities for matters such as legal actions, chemical demilitarization non-stockpile disposal, environmental restoration, and radioactive waste disposal. We excluded chemical demilitarization non-stockpile disposal, environmental restoration, and radioactive waste disposal from our review.

We ascertained which policies, procedures, and techniques were established and implemented to identify, evaluate, and report contingent legal liabilities arising from pending or expressly threatened litigation, likely claims, and assessments. We interviewed financial management and legal officials within the:

- Office of the Under Secretary of Defense (Comptroller) / Chief Financial Officer,
- DoD Office of General Counsel,
- Office of the Assistant Secretary of the Army (Financial Management and Comptroller),
- Department of the Army Office of the General Counsel,
- U.S. Army Legal Services Agency,
- U.S. Army Claims Service,
- Office of the Command Counsel, U.S. Army Materiel Command,
- Office of the Assistant Secretary of the Navy (Financial Management and Comptroller),
- Department of the Navy Office of the General Counsel,
- Department of the Navy Office of the Judge Advocate General,
- Office of the Assistant Secretary of the Air Force (Financial Management and Comptroller),
- Air Force Legal Services Agency,
- Air Force Materiel Command Law Office,
- Directorate of Resource Management, U.S. Army Corps of Engineers,
- Office of the Chief Counsel, U.S. Army Corps of Engineers, and
- Defense Finance and Accounting Service Centers.

We corroborated amounts reported as contingent legal liabilities in the FY 2004 financial statements of the Army General and Working Capital Funds, Navy General and Working Capital Funds, Air Force General and Working Capital Funds, and U.S. Army Corps of Engineers Civil Works Program against supporting source documentation such as journal vouchers, data call submissions, and legal representation letters.

We reviewed the processes employed to provide legal representations for the FY 2004 financial statements of the Army General and Working Capital Funds, Navy General and Working Capital Funds, Air Force General and Working Capital Funds, and U.S. Army Corps of Engineers Civil Works Program. In total, the above DoD reporting entities provided 196 legal representation letters representing a combined claim amount of \$323 billion.

We evaluated legal representation letters to determine whether the letters provided adequate information to enable the proper reporting of contingent legal liabilities in financial statements. We determined whether letters expressed opinions on the likely outcomes of cases, expressed opinions which were consistent with narrative, and identified potential monetary losses. We determined whether procedural or control weaknesses caused the submission of inadequate information.

We evaluated management summary schedules of legal representation letters to determine whether letters were accurately and completely summarized on schedules and properly disposed in financial statements and notes. We verified that information in legal letters, management schedules, and financial statements was consistent. We also assessed whether note disclosures provided sufficient information about conditions noted on the letters and schedules.

We performed this audit from August 2004 through August 2005 in accordance with generally accepted government auditing standards.

Use of Computer-Processed Data. We used computer-processed data contained within the Defense Departmental Reporting System to perform this audit. However, we did not rely on the processes to compile the data or controls over the data derived. We compared Defense Departmental Reporting System outputs to source documentation to conclude on the nature and accuracy of contingent legal liabilities reported in the FY 2004 financial statements.

Government Accountability Office High-Risk Area. The Government Accountability Office has identified several high-risk areas in DoD. This report provides coverage of the DoD Financial Management high-risk area.

Appendix B. Prior Coverage

During the last 5 years, GAO, the Department of Defense Inspector General (DoD IG), the U.S. Army Audit Agency, and the Air Force Audit Agency have issued ten reports discussing the financial reporting of legal loss contingencies, liabilities, or representations. Unrestricted GAO reports can be accessed over the Internet at <http://www.gao.gov>. Unrestricted DoD IG reports can be accessed at <http://www.dodig.mil/audit/reports>.

GAO

GAO Report No. GAO-05-407, “Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Continues to Need Improvement,” May 2005

GAO Report No. GAO-04-866, “Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Needs Further Improvement,” September 2004

GAO Report No. GAO-04-45, “Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Needs Improvement,” October 2003

DoD IG

DoD IG Report No. D-2004-028, “Independent Auditor’s Report on the Army General Fund Fiscal Year 2003 Principal Financial Statements,” December 3, 2003

DoD IG Report No. D-2003-0047, “Independent Auditor’s Report on the Army General Fund Fiscal Year 2002 Principal Financial Statements,” January 8, 2003

Army

U.S. Army Audit Agency Report No. AA 00-220, “Army’s General Fund Principal Financial Statements for Fiscal Year 1999: Financial Reporting of Liabilities,” April 21, 2000

Air Force

Air Force Audit Agency Report No. F2004-0003-FB3000, "Selected Aspects of Air Force Liability Reporting," October 22, 2003

Air Force Audit Agency Report No. F2002-0005-B05300, "Accounting for Air Force Liabilities, Fiscal Year 2001," July 29, 2002

Air Force Audit Agency Report No. 00053005, "Accounting for Air Force Liabilities, Fiscal Year 2000," August 31, 2001

Air Force Audit Agency Report No. 99053005, "Accounting for Air Force Liabilities, Fiscal Year 1999," October 27, 2000

Appendix C. Reliance on Legal Guidelines on Reporting Contingent Legal Liabilities

DoD representations regarding contingent legal liabilities were limited because financial management has relied solely on counsel for reporting contingent legal liabilities, and counsel usually evaluates the likelihood of an unfavorable outcome based strictly on the American Bar Association’s “Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information” (the ABA Policy Statement). The DoD Office of General Counsel contends that SFFAS No. 5, as amended by SFFAS No. 12, contradicts the ABA Policy Statement and that strict adherence to SFFAS No. 5 can potentially expose the legal posture of DoD, putting it at risk. The following table contrasts the differences between SFFAS No. 5 and the ABA Policy Statement.

Comparison of Accounting and Legal Guidelines		
Type of Opinion in Legal Representation Letters	SFFAS No. 5 (as Amended)	ABA Policy Statement
“Probable”	The future event is likely to occur	It is extremely doubtful that the client will prevail
“Reasonably Possible”	More than “Remote” but less than likely	Not Applicable
“Remote”	The chance of the future event occurring is slight	It is extremely doubtful that the client will not prevail
“Unable to Express an Opinion”	Not Applicable	Unable to advise as “Probable” or “Remote”

DoD Office of General Counsel. It is the DoD Office of General Counsel’s policy, consistent with the ABA Policy Statement, to generally decline to express an opinion concerning a case or claim, both in terms of the possible outcome and the amount of liability. DoD General Counsel maintains that:

- Privacy and protection of the legal representation letter is at risk because of the susceptibility of the letter to the Freedom of Information Act requests.

-
- ABA standards dictate that legal counsel assess as either “probable” or “remote” only in rare instances and that normally the assessment should be “unable to express an opinion.”
 - Determinations in accordance with SFFAS No. 5 and OMB requirements are viewed as potential violations of attorney-client privilege, requiring of a waiver from the Secretary of Defense, and may impair the ability of DoD to maintain confidentiality.
 - Estimating a dollar amount outcome of litigation is difficult because of the nuances of legal cases and the length of time for many of the cases.

OMB Bulletin No. 01-02 recognizes that legal counsels are to consider guidance contained in the ABA Policy Statement when making legal representations. However, it states that in order to satisfy management’s responsibilities under SFFAS No. 5, the Chief Financial Officer is required to document how the information contained in legal counsel’s response was considered in preparing the financial statements. DoD financial management is ultimately responsible for determining and documenting how contingent legal liabilities will be reported in the financial statements.

The ABA Policy Statement places stringent requirements on legal counsel when expressing judgments about pending litigation, claims, and assessments. If it is used exclusively, it leads counsel to express opinions only when there is near-absolute certainty; therefore, opinions of counsel are limited to “unable to determine.” DoD General Counsel stated that if counsel is forced to choose between the three categories, “remote” will be selected, as was the case with the Department of Army and USACE. The policy does not, in and of itself, satisfy the intent of reporting and disclosing contingencies. The following paragraphs provide information on rationale and a delineation of responsibilities for specific DoD Components.

Department of the Army. The Army Office of General Counsel acknowledged that they categorically limited opinions on likely outcome, regardless of case facts or anticipated outcome. In FY 2003, the Army Office of General Counsel did not express opinions in its legal representation letters on the likely outcome of pending legal cases. In FY 2004, Counsel elected to classify as “remote” all 77 cases reported in its legal representation letter. The Army Office of General Counsel stated that they previously refrained from expressing opinions because they did not want to reveal their legal posture. They limited opinions because furnishing such a judgment to outside legal channels might prejudice the Army’s position in its defense against litigation or a claim if a plaintiff obtained case reports under the Freedom of Information Act. However, Counsel stated that they would be willing to give a total number of “probable” or “reasonably possible” cases, but they did not want to reveal the probability on an individual basis.

Responsibilities for the contingent legal liability process are not clearly delineated within the Army. It is the position of the Office of the Assistant Secretary of Army (Financial Management and Comptroller) that the representations and the amounts submitted for reporting and disclosure are the exclusive responsibility of

the Army Office of General Counsel. The Army Office of General Counsel is of the opinion that the contingent legal liability process is the primary responsibility of the Office of the Assistant Secretary of the Army (Financial Management and Comptroller) and the representations are the Counsel's responsibility.

Department of the Navy. The Navy Office of General Counsel acknowledged that it limited its evaluations to "unable to express an opinion" concerning the likelihood of unfavorable outcome for all pending or threatened litigation and unasserted claims reported in FY 2004. Counsel limited opinions based on direction from the DoD Office of General Counsel and its strict interpretation of the ABA Policy Statement, which cautions lawyers against placing a value on a legal claim or estimating the likely result.

The Office of the Assistant Secretary of the Navy (Financial Management and Comptroller) relies solely on the legal representation process for reporting and disclosing contingent legal liabilities in the Navy General Fund and Working Capital Fund Financial Statements. Financial management stated that it is obligated to prepare the management schedules and report contingent legal liabilities based on opinions provided in the legal representation letters. Financial management acknowledged that the current process creates an inability to adequately report liabilities in the Navy financial statements.

Department of the Air Force. Legal counsel for the Air Force stated that they do not have any reservations about classifying cases as "probable" or "reasonably possible"; however, they stated that circumstances for certain cases may require an assessment of "unable to determine." Counsel provides the legal representation letters to auditors and submits the amounts for contingent legal liabilities to Defense Finance and Accounting Service (DFAS) Denver for reporting and disclosure on the financial statements. The Office of the Assistant Secretary of the Air Force (Financial Management and Comptroller) prepares the management schedule based solely on opinions and estimates provided in legal letters. It did not reconcile and explain differences between the legal letters, management schedule, and financial statements. Also, it did not review the amounts submitted to DFAS Denver. When issues with amounts occur, DFAS Denver works directly with counsel to resolve them. Financial management stated that it is responsible for accounting policy and that DFAS Denver serves as the accountants for the Air Force. Further, counsel is responsible for developing the estimation methodologies used to derive reportable liabilities.

U.S. Army Corps of Engineers. The USACE Office of the Chief Counsel follows the direction of the Army Office of General Counsel's policy to assess all cases as "remote." The USACE Office of the Chief Counsel stated that all cases were assessed as "remote" irrespective of the stage of litigation or anticipated outcome. In addition, Counsel stated that making determinations about the possible outcome of any litigation is difficult and subjective and could be used to demonstrate an admission of guilt on the part of the government, further exposing the government to higher litigation risk.

USACE financial managers rely solely on the representations made by the Office of the Chief Counsel. USACE financial managers stated that they did not know how to estimate contingent legal liabilities; however, USACE would include estimates on its financial statements if DoD established an acceptable methodology for estimating possible liabilities.

Management Comments on the Appendix

The Deputy Assistant Secretary of the Air Force (Financial Operations) disagreed with the statement “When issues with amounts occur, DFAS Denver works directly with counsel to resolve them.” He stated that financial management, DFAS, and legal representatives all worked together to resolve issues in FY 2004 and continue to do so in FY 2005. For the full text of his comments, see the Management Comments section of the report.

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)/Chief Financial Officer
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
Director, Program Analysis and Evaluation
DoD Office of General Counsel

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Commander, U.S. Army Corps of Engineers
Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Advanced Research Projects Agency
Director, Defense Commissary Agency
Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
Director, Defense Information Systems Agency
Director, Defense Intelligence Agency
Director, Defense Logistics Agency
Director, Defense Security Service
Director, Defense Threat Reduction Agency
Director, Missile Defense Agency
Director, National Geospatial-Intelligence Agency
Director, National Security Agency

Non-Defense Federal Organization

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Homeland Security and Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform
House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform
House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform

Office of Under Secretary of Defense (Comptroller) Comments



COMPTROLLER

OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

NOV 29 2005

MEMORANDUM FOR PROGRAM DIRECTOR, FINANCIAL RESOURCES
DIVISION, OFFICE OF INSPECTOR GENERAL,
DEPARTMENT OF DEFENSE

SUBJECT: Draft Report Entitled "DoD Process for Reporting Contingent Legal
Liabilities" (Project No. D2004-D000FA-0020.000)

Attached is our response to the subject draft report of October 7, 2005, provided to this office for review and comments. We appreciate the opportunity to review the draft and provide comments.

In general, we concur with your recommendations and will continue to work the Office of the General Counsel, DoD components, and other federal agencies to ensure proper reporting and disclosing of legal contingencies.

Also, we do not believe the Department's process for evaluating, estimating, and accounting for contingent legal liabilities is "perfunctory." My office works closely with the Office of the General Counsel to prepare the summary schedule of reported cases and to ensure proper reporting of legal contingencies.

My point of contact for this matter is Ms. Karen Nakama. She may be reached by e-mail at karen.nakama@osd.mil or by telephone at (703) 693-5657.

Teresa McKay
Deputy Chief Financial Officer

Attachment:
As stated

DoD OIG DRAFT REPORT DATED OCTOBER 7, 2005
DoD OIG D2004-D000FA-0202.000

DOD PROCESS FOR REPORTING CONTINGENT LEGAL LIABILITIES

RECOMMENDATION 1. The Office of the Under Secretary of Defense, Comptroller (OUSD(C))/CFO and the DoD Office of the General Counsel (OGC) establish a forum or other vehicle, with representation from the management and legal counsels from each of the DoD reporting entities, to mitigate the concerns of counsel. Specifically,

a. Develop solutions for providing meaningful assessments based on the requirements of the Statement of Federal Financial Accounting Standards No. 5, "Accounting Liabilities of the Federal Government," as amended, and Office of Management and Budget Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," amended July 27, 2004.

b. Develop and implement a uniform methodology for estimating, aggregating, and reporting contingent legal liabilities.

OUSD(C) RESPONSE 1a. Partially concur with comment. In reviewing the government-wide and several other federal agency financial statements, we noticed inconsistent reporting across the federal government. We will work with the Office of Management and Budget (OMB) and Treasury to ensure standardized reporting across the government, which can then be implemented across DoD. Also, we believe our process for reporting contingent legal liabilities is consistent with OMB Bulletin 01-02.

OUSD(C) RESPONSE 1b. We are unclear whether this recommendation refers to a legal definition of aggregation or a financial reporting definition. If this recommendation refers to a legal definition, we defer to the OGC. If this definition refers to a financial reporting definition, we concur and will comply with the recommendation.

RECOMMENDATION 2. The OUSD(C)/CFO revise DoD Regulation 7000.14-R, Financial Management Regulation (FMR) to ensure DoD and its Components consistently apply accounting and auditing standards cited in 1a and consistently disclose all contingent liabilities considered to be material to the financial statements.

OUSD(C) RESPONSE. Partially concur with comment. See response to 1a above. Upon follow-up discussions with the DoD Components, OGC, other federal agencies, OMB and Treasury we will revise the DoD FMR, as appropriate.

RECOMMENDATION 3. The USD(C)/CFO, Military Department Comptrollers, and the U.S. Army Corps of Engineers:

- a. Ensure that information on contingent liabilities in Note 16, Commitments and Contingencies, to the financial statements is fully supported and agrees with information in the legal representation letters and management schedule.
- b. Review and approve estimating methodologies and disclose, when applicable, those methodologies in Note 16 to the financial statements.
- c. Disclose in Note 16 to the financial statements the dollar value of claims that legal counsel is unable to express an opinion or unable to provide an estimate and range of estimates for contingent legal liabilities, if such contingent liabilities are material to the financial statements.

OUSD(C) RESPONSE 3a. Concur. We will ensure that the information in the financial statements is supportable, and agrees with information in the legal representation letters and management schedule.

OUSD(C) RESPONSE 3b. Concur. We will review, approve and disclose estimating methodologies as appropriate in the financial statements.

OUSD(C) RESPONSE 3c. Partially concur with comment. See response to 1a above. Upon follow-up discussions with the DoD Components, OGC, other federal agencies, OMB and Treasury we will disclose, if appropriate, the dollar value of claims that legal counsel is unable to express an opinion if such contingent liabilities are material to the financial statements.

DoD Office of General Counsel Comments*



DEPARTMENT OF DEFENSE
OFFICE OF GENERAL COUNSEL
1600 DEFENSE PENTAGON
WASHINGTON, DC 20301-1600

November 28, 2005

Mr. Marvin L. Peek
Office of the Assistant Inspector General for Auditing,
Department of Defense
Director, Defense Financial Auditing Service
400 Army Navy Drive (Room 814)
Arlington, VA 22202-4704

Dear Mr. Peek:

This is in response to your request for our comments on the Office of the DoD IG draft "Report on the Department of Defense Process for Reporting Contingent Legal Liabilities (Project No. D2004-D000FA-0202.000)". Thank you for the opportunity to comment on this report.

Following are general comments concerning some of the more significant aspects of the report. In addition to these comments there are two attachments to this letter, which are an integral part of this response. The first (TAB 1) contains specific responses to each of the recommendations contained in this report. The second (TAB 2) is a discussion related to an analysis by our office of the information contained in the contingency footnotes for each Fiscal Year 2004 CFO Act Agency; the Department of Homeland Security financial statement; and Government-wide financial statement.

Reporting Process

We have established an extensive and thorough process for collecting and evaluating all claims and contingencies at or above the annually established materiality thresholds for the DoD-wide financial statements. This process ensures that all material claims and contingencies pertaining to the Office of the Secretary of Defense and the Defense Agencies are identified and properly evaluated in connection with the interim and final legal representation letters for the DoD-wide financial statements that the General Counsel or Principal Deputy General Counsel of the Department of Defense sign in their capacities as the two chief legal officers of the Department. In addition, the same procedures used with respect to the Defense Agencies are used by the Military Departments so that information concerning Military Department cases arising at or above the DoD-wide materiality threshold is included with the legal representation letters.

As a result of the foregoing process, the information included with the legal



* 152-page attachment has been omitted from this report because of its length. Copies will be provided upon request.

representation letters for the DoD-wide financial statements is as complete and thorough as possible. It provides all information upon which informed and reasonable judgments may be made concerning the gravity and significance of the Department's claims and contingencies at or above the annually established materiality thresholds for the Department-wide financial statements.

In addition to legal representation letters for the DoD-wide financial statements, annual legal representation letters are also submitted for the Military Retirement Fund and the Medicare Eligible Retiree Health Care Fund financial statements.

Following is detailed information concerning the process used to insure the identification of cases for each of the legal representation letters that are signed by either the General Counsel or the Principal Deputy General Counsel of the Department of Defense. As will be seen from the following, considerable time and effort is expended in insuring that the information reported in all of the legal representation letters is complete, thorough, and accurate.

Each year, on or around the 15th of June, the Office of the Deputy General Counsel (Fiscal) (DoDGC (Fiscal)) sends out an email to the Defense Agency General Counsels¹ outlining the current year's requirements for legal representation letters. DoDGC (Fiscal) sends out three separate emails, one for the Medicare-Eligible Retiree Health Care Fund, one for the Military Retirement fund and one for the DoD Agency-Wide Financial Statements. The DoD Defense-Wide email is also sent to the Military Departments. Each email details the requirements outlined in both the DoD Comptroller's memorandum and the DoDIG's letter requesting the representation letters. The tasking email also includes the cases that were reported the previous year and the accepted format for reporting current cases. We direct that the Defense Agencies and Military Departments respond approximately two to three days after the effective dates for the interim and final letters. Responses are then read, reviewed and compiled by an action attorney for the Deputy General Counsel (Fiscal)'s review and ultimately the Principal Deputy General Counsel or General Counsel signature.

The foregoing process involves the expenditure of no less than 50 hours of attorney effort within the DoD Office of the General Counsel alone. This time is in addition to the time spent by the General Counsel of the Defense Agencies and the military departments in complying with the requests for information in connection with the submission of the interim and final legal representation letters. All information received and reported in connection with the legal

¹ The DoD Defense Agencies are composed of: DoD Counterintelligence Field Activity, Defense Advanced Research Project Agency, Defense Acquisition University, Defense Contract Audit Agency, Missile Defense Agency, Defense Commissary Agency, Defense Finance and Accounting Service, Defense Human Resources Activity, Defense Intelligence Agency, Defense Information Systems Agency, Defense Logistics Agency, DoD Education Activity, Defense Security Cooperation Agency, Defense Security Service, Defense Threat Reduction Agency, Defense Technology Security Administration, The DoD Inspector General, National Defense University, National Geospatial-Intelligence Agency, National Reconnaissance Office, National Security Agency, Defense POW/Missing Persons Office, Tricare Management Activity/ Uniformed Services University of the Health Sciences and Washington Headquarters Services.

representation letters is subject to detailed review by the DoDGC action attorney, the Deputy General Counsel (Fiscal) and by the Principal Deputy General Counsel of the Department of Defense and/or the General Counsel of the Department of Defense.

In addition, each of the military departments must submit legal representation letters for their individual financial statements and they follow a process essentially similar to that utilized within the DoDGC. Each of the military departments also is responsible for submitting not one, but at least two, interim and final legal representation letters, for both their General and Working Capital Funds. The Army's reports also involve providing information concerning the military functions of the Corps of Engineers. All told, it is estimated that the same amount of time spent in the DoDGC is spent at the action attorney and executive levels of each of the Offices of the General Counsel of the Army, Navy and Air Force.

As reflected above, extensive resources at the highest levels of the Department are expended in insuring that the legal representation letters submitted for Department-wide financial statements, including those pertaining to the Retirement and Medicare-Eligible Retiree Health Care Funds, and the general and working capital funds of the Military Departments are accurate and complete. In view of this there is absolutely no basis for the statement on page 5 of the draft report that "The DoD process for evaluating, estimating and accounting for contingent legal liabilities is perfunctory..."²

ABA Standards

There are numerous references to the American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information³ in both the DoDIG's draft report as well as the DoDIG's Sample of Management's Request to Legal Counsel For a Legal Representation Letter, but nowhere is ABA policy expressly addressed. The DoDIG's sample specifically states that the ABA Policy "provides relevant guidance for the lawyer's response to the auditor's request,"⁴ however, the report fails to discuss the actual guidance contained in the ABA policy in any meaningful manner. When the policy is discussed at all, there is no acknowledgment of the direct relationship between the statement of policy and a lawyer's professional and ethical obligations toward the lawyer's client. Totally ignored is the fact that the method of reporting cases and the practice of generally declining to express an opinion concerning outcomes and limits of liability by the Department of Defense is, and has always been, consistent with the ABA standards. This fact was even attested to by one of the original authors of the ABA standards, who was a consultant to the Government when the Government's process for issuing legal representation letters was in its earliest stages. In this regard, it should be noted that, while rare, the Department has consistently expressed opinions

² Office of the Inspector General, Department of Defense, draft, "Report on the Department of Defense Process for Reporting Contingent Legal Liabilities (Project No. D2004-D000FA-0202.000)," page 5.

³ American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975).

⁴ Sample Management Request To Legal Counsel For A Legal Representation Letter, Feb2, 2005.

concerning possible outcomes of cases when the facts of a case support such an opinion. Other aspects concerning this exercise of professional judgment by attorneys, are discussed at the end of this response.

The most significant element of the Policy concerns whether or not a lawyer should express an opinion concerning the outcome of a case and the potential amount of loss if an unfavorable outcome is anticipated. In addressing these issues, the Statement of Policy provides:

The information that lawyers may properly give to the auditor concerning the foregoing matters [overtly threatened or pending litigation] would include (to the extent appropriate) an identification of the proceedings or matter, the stage of proceedings, the claim(s) asserted, and the position taken by the client.

In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcomes except in those relatively few clear cases where it appears to the lawyer that an outcome is either "probable" or "remote."

The lawyer may also be asked to estimate, in dollar terms, the potential amount of loss or range of loss in the event that an unfavorable outcome is not to be viewed as "remote." In such a case, the amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.⁵

The foregoing has traditionally been reflected in the Department's practice that lawyers generally decline to express an opinion concerning a case or claim, both in terms of the possible outcome and the amount of any liability, unless clearly justified and supported by the facts of a particular case. For example, where a judgment on the merits has been entered against the Government, no appeal will be taken, and the sole issue remaining is determination of the quantum of damages, it would be appropriate to indicate that a loss in the case is "probable"; however, unless an amount were clearly determinable (which is most unlikely in view of any on-going litigation on the quantum of damages) lawyers would still decline to express an opinion concerning the amount of any liability.

With respect to the foregoing, the format for reporting cases developed for general Government use in connection with an auditor's review of financial statements does not specifically recognize the lawyers' inability to state an opinion concerning the possible outcome of a case. We do not consider this fact to be controlling on how the lawyers of the Department of Defense will respond to their ethical and professional responsibilities when reporting cases.

⁵ American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information, page 218.

Therefore, within the Department, paragraph 5 of the Department's standard case report form, "An evaluation of the likelihood of unfavorable outcome", normally includes the category, "Unable to Express an Opinion Concerning the Likely Outcome of this Case." A similar statement has normally been made in paragraph 6 "An Estimate of the Amount or Range of Potential Loss" of the form.

We consider that the inclusion of the foregoing statements and their general use for most cases is totally consistent with the American Bar Association standards. In addition, it is impossible to predict how any judge or jury will act in virtually any case that they may consider. Therefore, the inclusion and use of these statements for both the outcome and amount of loss portions of the Department's standard case reporting forms is, as reflected above, consistent with the ABA Statement of Policy. This is not to imply that opinions should never be expressed; however, when made, the opinions should be factually supportable and realistic.

Aggregation of Cases

This issue is not new. It arose when the first legal representation letters were being prepared within the Department. At that time, there was general acknowledgment within the legal community and the auditing community that cases should be aggregated only when numerous cases arose from a single fact or circumstance. Until now, there has been no question concerning the reasonableness of this approach. During the course of this audit, it is clear that the original consensus, however reasonable, no longer exists. We adhere to the concept that cases should only be aggregated when cases and the underlying principles are clearly identical. This is consistent with reporting of cases "at or above" the materiality threshold. To aggregate cases below the threshold until they reach that threshold, on the other hand, would mandate the collection and reporting of information concerning each and every case or controversy against the Department. In this regard, it is noted that, in the private sector, generally the only "aggregated cases" are class action cases.

In addition to determining that separate lawsuits would be impractical or burdensome, the conditions that must exist to certify a class action lawsuit are that the plaintiffs are similarly situated and the defendants, basic facts, and legal issues are the same. While we are not opposed to the concept of aggregation, and in fact have aggregated two cases on at least one occasion involving a medical malpractice claim where there was a single medical procedure, a single doctor, but two claimants, we believe that the factors applicable to class action determinations should be the foundation for any aggregation.

We do not agree that immaterial cases can be made material simply by aggregating. This seems to be what the DoD IG is saying in the comment that the "DoD did not report on immaterial cases that, in aggregate, exceeded materiality thresholds established by the auditors."⁶

⁶ Office of the Inspector General, Department of Defense, draft, "Report on the Department of Defense Process for Reporting Contingent Legal Liabilities (Project No. D2004-D000FA-0202.000)," Executive Summary, page i.

The Office of the DoDIG does not articulate any standards that it believes should be used to determine the nature or extent of aggregation. In one part of the report, the comment is made that:

In the past we have used the guidelines in OMB Bulletin No. 01-02 or the President's Council on the Integrity and Efficiency Financial Audit Manual, based **on the assumption** that legal counsel would aggregate smaller cases that did not meet the reporting threshold for individual cases. [emphasis added]⁷

In our opinion, the aggregation of smaller cases is not required and is not supportable by either the OMB Bulletin or the Financial Audit Manual. The OMB bulletin states that "[c]ases **similar in nature** should be aggregated where appropriate."⁸ [emphasis added]. The requirement that cases be "similar in nature" should be construed to mean that the "plaintiffs must be similarly situated and the defendants, basic facts, and legal issues must be the same." That is to say, the OMB bulletin's reference to similarity in nature is just a shorthand encapsulation of the conditions that must be met before individual cases can be certified as a class action.

The report stresses that there are numerous smaller claims that, added together, create a large potential liability. In the Army's case the report states that there were a total of \$24.8 billion in claims that are unaccounted in the legal representation letter process. In numerous discussions with the DoDIG, we have attempted to convey that the aggregate dollar amount of all claims does not reflect the amount of losses that the Army might face as a result of these claims. This is apparent in view of the well-known fact that plaintiff's attorneys regularly inflate claims to the point that the claimed amount bears no relationship to the actual amount that might be recovered, even if the plaintiff were successful. Again, to report the total dollar amount of all cases, no matter how factually unrelated or no matter what underlying legal principles are involved would be to totally ignore the concept that only material cases are to be reported. It would, in effect, make a nullity out of establishing materiality thresholds in the first place. This cannot be the result contemplated or required by any accounting principle or standard. Rather than enhancing the Department's financial statements, adoption of the reports recommendations would undermine the fairness, accuracy, and completeness of those statements.

Aside from any consideration about the realities of litigation, as a practical matter, aggregation of the type apparently envisioned by the DoD IG would be a massive undertaking. This would, in fact, require each case to be separately listed and evaluated. In April 2005, the U.S. Army Claims Service alone reported 1,025 claims on hand. It is clearly not the OMB Bulletin's intent to create the onerous requirement to review every case within the Department, which is exactly what is required for the Department to comply with this request. In subsequent conversations, the Office of DoDIG has suggested that the Military Departments could speculate

⁷ *ibid*, page 11.

⁸ Office of Management and Budget Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," October 16, 2000, page 35.

as to some percent of liability that the Department might incur. We believe that such speculation is inappropriate in this process.

Reporting Requirements

On page three of the report the DoDIG states:

DoD management has not taken ownership over the process, bridging the gaps between financial accounting and reporting requirements, and guidance issued by the American Bar Association. As a result, the DoD and its Components' representatives do not contain sufficient evidence for auditors to assess the presentation or disclosure of legal loss contingencies on the DoD financial statements. If the risk and uncertainty for contingent liabilities is not adequately assessed, supported, and disclosed on the financial statements, DoD (and perhaps the Federal Government) will not be able to receive a favorable opinion on future financial statements⁹

This statement is not supported by the facts concerning the reporting of contingencies within the Federal Government. As indicated previously, our office has reviewed each of the contingency footnotes for the FY 2004 CFO Act agency financial statements; the Department of Homeland Security financial statements and the Government-wide financial statement.¹⁰ (TAB 2) While a number of the footnotes express an opinion on the outcome of cases as probable, reasonably possible, or remote and state dollar amounts for the probable and reasonable cases, a number do not contain this information. The footnotes relating to the private sector companies that were reviewed by this Office reflect a similar treatment.

How claims and contingences are reported does not seem to affect whether an agency receives a qualified or unqualified opinion. As the attachment shows, this was determined by reviewing the financial statement footnotes for those agencies that received an unqualified opinion by auditors who concluded that the reports fairly presented the financial condition of the entity being reviewed, in accordance with generally accepted United States accounting principles. After reviewing this information, it is hard to ascertain any single method for reporting cases or expressing an opinion concerning their outcome or anticipated amount of liability. It seems that there is no basis in fact for the draft report's assertion that to continue to follow the Department's practice, which is similar to the practice in many of the public and private sector entities, will result in footnotes that do not contain sufficient evidence for auditors to assess the presentation or disclosure of legal loss contingencies on the DoD financial statements.

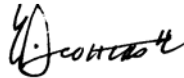
⁹ Office of the Inspector General, Department of Defense, draft, "Report on the Department of Defense Process for Reporting Contingent Legal Liabilities (Project No. D2004-D000FA-0202.000)," page 3.

¹⁰ The referenced footnotes are available upon request, but due to space limitations, we did not include these footnotes in this response.

Professional Judgment

In a number of instances in the draft report, the Office of DoDIG appears to substitute its judgment for advice and determinations of Military Department legal counsel. For example, the report questions the rationale for the Navy's professed inability to express an opinion on cases that are in settlement negotiations.¹¹ For numerous reasons, settlement discussions are too speculative to determine the likelihood of an outcome. There is every possibility that the settlement discussion will fail and the case will be tried on the merits. Likewise there are several cases in which Air Force and Army settlement negotiations are questioned as reasons for the Departments to express an inability to determine the outcome of such cases. Negotiations are indicative of nothing other than the fact that discussions are underway between the parties. If these cases were reported in any other way, the reporting attorney would be violating the ABA policy.

Please see our specific responses to the report recommendations at Tab 1. Once again thank you for the opportunity to comment on this report. If you have any questions, please contact Robert Paschall at 703-571-9342.



E. Scott Castle
Deputy General Counsel (Fiscal)

¹¹ Office of the Inspector General, Department of Defense, draft "Report on the Department of Defense Process for Reporting Contingent Legal Liabilities (Project No. D2004-D000FA-0202.000)," page 7.

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE

Draft Audit Report, DoD Process for Reporting Contingent Legal Liabilities
(Project No. D2004-D000FA-0202.000)

Recommendation 1.a: We recommend that the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Office and the DoD Office of General Counsel establish a forum or other vehicle, with representation from the management and legal counsel from each of the DoD reporting entities, to mitigate the concerns of counsel. Specifically,

a. Develop solutions for providing meaningful assessments based on the requirements of the Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," as amended, and the Office of Management and Budget Bulletin No 01-02, "Audit Requirement for Federal Financial Statements," amended July 27, 2004.

DoDGC Comments: Partially Concur. From our review of the FY 2004 CFO Act agency financial statement footnotes, and those for the Department of Homeland Security and the Government-wide financial statement, we believe that this should be elevated for Government-wide consideration. Otherwise, the proliferation of different approaches, none of which seems to preclude other auditors from rendering an unqualified opinion, will continue.

We do not concur with any suggestion that the current process for reporting legal contingent liabilities is not fully compliant with the requirements of OMB Bulletin 01-02. We believe that our process for reporting contingent legal liabilities is fully consistent with the plain meaning of OMB Bulletin 01-02, and is reasonable and appropriate. As previously stated, the OMB Bulletin reads "[c]ases similar in nature should be aggregated where appropriate."¹² Most significantly, OMB Bulletin 01-02 also states that legal counsel shall consider the guidance contained in the American Bar Association's "Statement of Policy Regarding Lawyers' Responses to Auditors' Request for Information (December 1975) in preparing their responses."¹³ The entire legal community within the Department has followed this direction and fails to see how this approach falls short of the requirements of the OMB Bulletin.

¹² OMB Bulletin 01-02, page 35.

¹³ *ibid*, page 11.

Recommendation 1b. Develop and implement a uniform methodology for estimating, aggregating and reporting contingent legal liabilities.

Revised

DoDGC Comments: We are unclear whether this recommendation refers to a legal definition of aggregation or a financial reporting definition. If this recommendation refers to a financial reporting definition, we defer to DoD Comptroller. If this refers to a legal definition of aggregation, we non-concur. The procedures, principles and guidelines followed by the General Counsel of the Department of Defense and the Military Departments for the collection and reporting of cases is compliant with all standards applicable to a lawyer's professional responsibilities and duties. In view of the inherent uncertainties applicable to cases, we fail to see how any meaningful mechanism could be developed which would result in any useful estimates of legal liabilities. It is our view that any such estimates would be speculative and would do nothing to advance the goal of having fair and accurate financial statements.

Recommendation 2. We recommend that the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer publish policy in the DoD Financial Management Regulation 7000.14-ZR to ensure DoD and its Components consistently apply accounting and auditing standards cited in 1.a and consistently disclose all contingent liabilities considered to be material to the financial statements.

DoDGC Comments: While we defer to the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer on this recommendation, we reiterate our comments from 1.a and believe that the Department fully complies with OMB Bulletin 01-02.

Recommendation 3.a: Ensure that amounts accrued in "Other Liabilities" and information disclosed for contingent liabilities in Note 16 to the financial statements is fully supported and agrees with information in the legal representation letters and management schedule.

Recommendation 3.b: Review and approve estimation methodologies and disclose, when applicable, those methodologies in Note 16 of the financial statements.

Recommendation 3.c: Disclose in Note 16 to the financial statements the dollar value of claims that legal counsel is unable to express an opinion or unable to provide an estimate or range of estimates for contingent legal liabilities, if such contingent liabilities are material to the financial statements.

DoDGC Comments:

Recommendation 3a.: We concur that the contingencies footnote should reflect the information contained in the legal representation letters; however, we do not believe that all of the information in that footnote must be included in the legal representation letters. The information in the legal representation letters is based on specific cases and controversies. As long as that information is accurately reflected in the footnote, there should be no reason why other information not related to the information contained in the legal representation letter could not be

disclosed in the footnote, as long as the basis on which it is being reported is clearly identified and distinguished from legal representation letter information. As mentioned above and in the attached document (TAB 2) our office reviewed the footnotes of each of the FY 2004 CFO Agencies; the Department of Homeland Security, and the Government-wide financial statements. In addition we reviewed comparable footnotes for General Motors, Home Depot, Lowes, Costco, WAL-MART, Microsoft, and Target. Review of both the public and private sector contingency footnotes shows that:

- There is no uniformity in how claims and cases are reported in contingency footnotes.
- How claims and contingencies are reported does not seem to affect whether or not an unqualified opinion is received.
- Based upon the myriad approaches to presenting and discussing contingencies and litigation, and the fact that unqualified opinions are rendered no matter how contingencies and litigation are addressed, it seems that there is no single principle within the realm of generally accepted accounting principles dictating whether or not case outcomes and monetary estimates of potential losses need to be expressed either in the financial statement themselves or the footnotes.
- Many footnotes in both the public and private sector contain information that is in addition to the information contained in the legal representation letters .

Recommendation 3b: We defer to the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer. While an accountant or a statistician might be able to develop some estimation methodology, we question the utility of any information that might be developed as a result. In view of the inherent uncertainties of all litigation, projecting past results onto current facts would appear to be highly speculative. We do not believe that there would be any obstacle to presenting this information in the footnote as long as it was made clear that the information was derived as the result of statistical or accounting sampling and was not based on any evaluation by an attorney concerning the outcome of any pending cases.

Recommendation 3c: We defer to the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer. There is no legal objection to presenting this information; however, we question its utility. Again, we do not believe that there would be any obstacle to presenting this information in the footnote as long as it was made clear that the information was derived as the result of statistical or accounting sampling and was not based on any evaluation by an attorney concerning the outcome of any pending cases.

Department of the Army Comments



REPLY TO
ATTENTION OF

DEPARTMENT OF THE ARMY
OFFICE OF THE ASSISTANT SECRETARY OF THE ARMY
FINANCIAL MANAGEMENT AND COMPTROLLER
109 ARMY PENTAGON
WASHINGTON DC 20310-0109

NOV 30 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDITING,
DEPARTMENT OF DEFENSE OFFICE OF INSPECTOR GENERAL, 400 ARMY
NAVY DRIVE, ARLINGTON, VA 22202-4704

SUBJECT: Draft Audit Report, DoD Process for Reporting Contingent Legal
Liabilities (Project No. D2004-D000FA-0202.000)

We have reviewed the subject draft report and enclosed our comments.
Point of contact is Mr. Imtiaz Badar who can be reached at (703) 693-2687, DSN
223-2687, Email: imtiaz.badar@hqda.army.mil.


John J. Argodale
Deputy Assistant Secretary of the Army
(Financial Operations)

Enclosure

Official Command Comments:

Recommendation 3.a: Ensure that amounts accrued in "Other Liabilities" and information disclosed for contingent liabilities in Note 16 to the financial statements is fully supported and agrees with information in the legal representation letters and management schedule.

Command Comments: Concur

Financial reporting information including accrued and/or disclosed contingent liabilities should be adequately supported for financial reporting. Office of the Assistant Secretary of the Army (Financial Management and Comptroller) will coordinate with the Office of the Army General Counsel to ensure information provided for financial reporting has required support and audit trails. Furthermore, Office of the Assistant Secretary of the Army (Financial Management and Comptroller) will also assess whether amounts accrued for "Other Liabilities" and Note 16 disclosures agree with the legal representation letters where applicable.

However, future Note 16 contingent liability disclosures may differ from legal representation letter information due to document preparation considerations that apply. For example, the legal representation letter must be prepared using reporting thresholds for potential loss as agreed upon by the Office of the Inspector General – Department of Defense and the client; while Note 16 is not compiled with such parameters.

The completion date for this action is 2nd Quarter FY 2006.

Recommendation 3.b: Review and approve estimation methodologies and disclose, when applicable, those methodologies in Note 16 of the financial statements.

Command Comments: Concur

Office of the Assistant Secretary of the Army (Financial Management and Comptroller) will coordinate with the Office of the Army General Counsel to review and approve estimation methodologies and disclose, when applicable, those methodologies in Note 16 of the financial statements. Approval will be contingent upon Office of the Army General Counsel adherence to applicable regulation and guidance for compiling contingent liabilities for financial reporting. The completion date for this action is 2nd Quarter FY 2006.

Recommendation 3.c: Disclose in Note 16 to the financial statements the dollar value of claims that legal counsel is unable to express an opinion or unable to provide an estimate or range of estimates for contingent legal liabilities, if such contingent liabilities are material to the financial statements.

Command Comments: Partially Concur

Office of the Assistant Secretary of the Army (Financial Management and Comptroller) will coordinate with the Office of the Army General Counsel to gather and assess the dollar value of claims that legal counsel is unable to express an opinion or unable to provide an estimate or range of estimates. Disclosure of this information will not be limited to materiality thresholds and will take in to account the many complexities of assessing claims. The completion date for this action is 2nd Quarter 2006.

Enclosure

Department of the Navy Comments



THE ASSISTANT SECRETARY OF THE NAVY
(FINANCIAL MANAGEMENT AND COMPTROLLER)
1000 NAVY PENTAGON
WASHINGTON, DC 20350-1000

21 November 2005

MEMORANDUM FOR OFFICE OF THE INSPECTOR GENERAL, DEPARTMENT OF
DEFENSE

Subj: INSPECTOR GENERAL, DEPARTMENT OF DEFENSE, DRAFT AUDIT
REPORT, DOD PROCESS FOR REPORTING CONTINGENT LEGAL
LIABILITIES, REPORT NO. D2004-D000FA-0202.000

Encl: (1) OASN (FM&C) Comments/Responses

The subject draft audit report number D2004-D000FA-0202.000 of 7 October 2005 criticizes the Department of Defense and, in particular, the Department of Navy for its assessments of the expected outcome of legal cases. However, there is simply no basis to conclude that the Department of Navy's failure to express an opinion concerning either the outcome or potential liability in a particular case is contrary to any generally accepted accounting principle. Determinations for reporting the expected outcome of cases and claims against the government cannot be based on a formula. In fact, in light of the inherent uncertainty of litigation, any expression of an opinion as to the merits of a particular case, its likely outcome, and the amount of any potential liability must be based on the facts of the cases being reported and the competence of the attorneys to make such expressions. As in all situations regarding the Department of Navy's financial statements, the question with regard to the legal contingencies is whether the manner of reporting cases is consistent with a fair and accurate presentation of financial status of the reporting agency. The expressions of potential liability made by the Department of the Navy are the most fair and accurate statements that can be made concerning its reported cases.

This is not to imply that opinions should never be expressed. However, when definitive expressions concerning potential outcome or amount of loss are made the opinions should be factually and logically supportable. In this regard, it would be just as erroneous to report a liability or to make an estimate of a liability when there is no valid basis or method for doing so as it would be to fail to report such a liability when supported by the facts. The Department of the Navy's expressions concerning case outcomes and potential liabilities have been completely consistent with the facts of the cases being reported, the realities of litigation, and the American Bar Association guidelines concerning such reports. They are also in strict conformance with specific guidance from the Office of General Counsel for the Department of Defense. Therefore, they are consistent with the overarching generally accepted accounting principle that financial statements must fairly and accurately present the financial and other facts pertaining to an entity's financial statements.

In addition to the above comments, please see enclosure (1) for the Department of the Navy's specific responses to the recommendations made in the draft report. My point of contact is Ms. Valerie Wenderoth, who can be reached at (703) 695-0783, or via e-mail at Valerie.Wenderoth@navy.mil.



Richard Greco, Jr.

Copy to:
Under Secretary of Defense (Comptroller)
Department of the Navy General Counsel
Department of Defense Deputy General Counsel (Fiscal)

Assistant Secretary of Navy (Financial Management & Comptroller)
Comments on Draft DODIG Audit Report,
"DOD Process for Reporting Contingent Legal Liabilities"
(Project Number D2004-D000FA-0202.000)

Recommendation 1.a. Develop solutions for providing meaningful assessments based on the requirements of the Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," as amended and Office of Management and Budget Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," amended July 27, 2004.

Comment: Concur with caveat. DoD cannot simply ignore or disregard the American Bar Association's "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information." That statement specifically provides,

The information that lawyers may properly give to the auditor concerning the foregoing matters [overtly threatened or pending litigation] would include (to the extent appropriate) an identification of the proceedings or matter, the stage of proceedings, the claim(s) asserted, and the position taken by the client. In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to the outcomes except in those relatively few clear cases where it appears to the lawyer that an outcome is either "probable" or "remote." The lawyer may also be asked to estimate, in dollar terms, the potential amount of loss or range of loss in the event that an unfavorable outcome is not viewed as "remote." In such a case, the amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.

The format for reporting cases developed for general Government use in connection with an auditor's review of financial statements does not specifically recognize the lawyers' inability, except in very rare situations, to state an opinion concerning the possible outcome of a case or amount of potential loss. DOD has included a category "Unable to Express an Opinion Concerning the Likely Outcome of this Case," which is consistent with both the ABA Statement of Policy and the reality of litigation.

Recommendation 1.b. Develop and implement a uniform methodology for estimating, aggregating, and reporting contingent legal liabilities.

Comment: Concur in part. It is critical that OSD establish a uniform methodology for the aggregation of cases and provide each of the military services a legal definition that will be used to aggregate the cases where applicable. However, the draft report should not portray the Department of the Navy as providing minimum information on aggregated claims. DODIG has not developed a clear definition of the term. In fact, the Memorandum for the DOD Office of

General Counsel calling for legal representation letters for Fiscal Year 2005 only mentions aggregation once stating, "Cases similar in nature should be aggregated where appropriate." Thus, the Department of the Navy instructs its activities to report cases that meet the DODIG's materiality threshold and that the materiality threshold should be applied to both individual and aggregate claims arising out of a single event (litigation, claim or assessment), or series of events. This seems to meet the DODIG's own requirement as stated in its memorandum. The Department of the Navy nonconcurs with the remainder of the recommendation. In accordance with current guidance, cases that are reported in the Legal Representation Letters have an associated amount, therefore, there is no need for OSD to develop estimating methodology. In fact, the methodology would just be another element subject to an audit. Further, OSD has developed a uniform methodology for reporting contingent legal liabilities and it is in compliance with the American Bar Association's "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information."

Recommendation 2. Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer publish policy in the DoD Financial Management Regulation 7000.14-R to ensure DoD and its Components consistently apply accounting and auditing standards cited in 1.a. and consistently disclose all contingent legal liabilities considered to be material to the financial statements.

Comment: Nonconcur to the extent that it suggests that DOD ignore the American Bar Association's "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information."

Recommendation 3.a. Ensure that amounts accrued in "Other Liabilities" and information disclosed for contingent liabilities in Note 16 to the financial statements is fully supported and agrees with information in the legal representation letters and management schedule.

Comment: Concur. The DON already does this.

Recommendation 3.b. Review and approve estimation methodologies and disclose, when applicable, those methodologies in Note 16 of the financial statements.

Comment: Nonconcur. Estimating methodologies only add complexity and questions. It has not been shown that generally accepted accounting principles require any single method for reporting cases or for the expression of an opinion concerning the outcome or anticipated amount of liability with respect to the cases. A review of other CFO Act Agencies' Financial Statements indicates that there is no uniformity in reporting methodology. There is no single principle with generally accepted accounting principles setting forth a method for whether a case outcome and potential loss needs to be expressed in the financial statements in the footnotes and this lack of a single method does not seem to affect whether an unqualified opinion is achieved.

Recommendation 3.c. Disclose in Note 16 to the financial statements the dollar value of claims that legal counsel is unable to express an opinion or unable to provide an estimate or range of estimates for contingent legal liabilities, if such contingent liabilities are material to the financial statements [emphasis added].

Comment: Nonconcur. The manner of reporting cases must be consistent with a fair and accurate presentation of the financial status of the reporting agency and is at management's discretion. Each and every case and situation needs to be evaluated in the context of its unique situation. Where opinions are made, the opinions should be factually and logically supportable.

Department of the Air Force Comments



DEPARTMENT OF THE AIR FORCE
WASHINGTON, DC

OFFICE OF THE ASSISTANT SECRETARY

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDITING
OFFICE OF THE INSPECTOR GENERAL
DEPARTMENT OF DEFENSE

FROM: SAF/FMP

SUBJECT: DoDIG Draft Audit Report, DoD Process for Reporting Contingent Legal Liabilities, (Project D2004-D000FA-0202.000), Suspense: 28 Nov 05

1. This is in reply to your memorandum requesting the Office of the Assistant Secretary of the Air Force (Financial Management and Comptroller) provide comments on subject draft report.
2. Overall, the Office of the Assistant Secretary of the Air Force (Financial Management and Comptroller) concurs with comments made in Appendix C. Reliance on Legal Guidelines on Reporting Contingent Legal Liabilities for FY04 financial statements. However, the statement, "When issues with amounts occurs, DFAS-Denver works directly with counsel to resolve them," is untrue. The Air Force financial management representative, the DFAS analyst and the legal counsel representative all worked together to resolve issues in FY04, and continue to do so in FY05. Additionally, in FY05, Air Force financial management personnel not only reviewed amounts submitted to DFAS-Denver accountants, but also reconciled and agreed with amounts booked in Note 15, "Other Liabilities," and disclosed in Note 16, "Commitments and Contingencies."
3. **Recommendation 3.** We recommend that the Office of the Assistant Secretary of the Air Force (Financial Management and Comptroller):
 - a. Ensure that amounts accrued in "Other Liabilities" and information disclosed for contingent liabilities in Note 16 to the financial statements is fully supported and agrees with information in the legal representation letters and management schedule.

MANAGEMENT COMMENTS. Concur. Office of the Assistant Secretary of the Air Force (Financial Management and Comptroller) currently reviews, examines and reconciles amounts accrued in Note 15, "Other Liabilities," and information disclosed in Note 16, "Commitments and Contingencies." Air Force financial management personnel will continue to work with legal counsel to ensure that differences between the legal letters, management schedule and financial statements are reconciled and explained. Financial management personnel will also ensure legal representation letters and the management schedule fully substantiate amounts reported and disclosed as contingent legal liabilities on its financial statements.

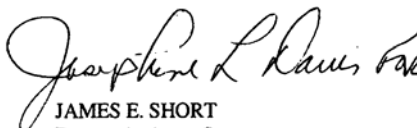
b. Review and approve estimation methodologies and disclose, when applicable, those methodologies in Note 16 of the financial statements.

MANAGEMENT COMMENTS. Concur. Office of the Assistant Secretary of the Air Force (Financial Management and Comptroller) will work with legal counsel to ensure the management schedule and legal representation letters disclose the estimation methodologies used to derive reportable contingent legal liabilities. Air Force financial management personnel will review the methods used to estimate the contingent legal liabilities - recognizing cases that individually are material and applying an historical payout rate to all other cases - ensuring they are calculated accurately and consistently, and will disclose in Note 16, "Commitments and Contingencies," when applicable.

c. Disclose in Note 16 to the financial statements the dollar value of claims that legal counsel is unable to express an opinion or unable to provide an estimate or range of estimates for contingent legal liabilities, if such contingent liabilities are material to the financial statements.

MANAGEMENT COMMENTS. Nonconcur. According to SFFAS No. 5 and DoDFMR Vol 6B, the DoD is required to report a contingent legal liability on the balance sheet when an unfavorable outcome is "probable" and measurable, and disclose a contingent legal liability in the notes to the financial statements when an unfavorable outcome is at least "reasonably possible." No disclosure is required if there is a "remote" chance of a loss. If legal counsel is unable to classify a claim as "probable," "reasonably possible" or "remote," and no other reporting and evaluation process is used, it is understandable to disclose the dollar value of claims in Note 16. However, as noted in the DoDIG Draft Audit Report, DoD Process for Reporting Contingent Legal Liabilities, *DoD Procedures for Compiling and Reporting Contingent Legal Liabilities*, Department of the Air Force, pages 7 through 9, the Air Force employs acceptable evaluation and reporting processes. The Air Force does, can, and will continue to employ evaluation and reporting processes that satisfy the intent of SFFAS and OMB reporting requirements.

3. Please direct any questions to Connie Ward, SAF/FMPS, (703) 697-6465.



JAMES E. SHORT
Deputy Assistant Secretary
Financial Operations
(Financial Management)

U.S. Army Corps of Engineers Comments



DEPARTMENT OF THE ARMY
U.S. ARMY CORPS OF ENGINEERS
441 G ST. NW
WASHINGTON, D.C. 20314-1000

CEIR

5 December 2005

MEMORANDUM FOR THE AUDITOR GENERAL, ATTN: SAAG-PMO, 3101
Center Park Drive, Arlington, VA 22302

SUBJECT: Draft DoDIG Audit Report - DoD Process for Reporting Contingent
Legal Liabilities (Project No. D2004-D000FA-0202.000)

We have reviewed the subject draft report and enclosed our comments.
Point of contact is Ms. Raylonda F. Bell who can be reached at (202) 761-1371,
DSN 763-1371, Email: Raylonda.F.Bell@hq02.usace.army.mil.

FOR THE COMMANDER:


DONNA F. JOHNSON
Acting Chief of Internal Review
Headquarters, U. S. Army Corps of Engineers

Copy Furnished:
CERM-F

DODIG DRAFT REPORT – 7 OCTOBER 2005 – DOD PROCESS FOR REPORTING CONTINGENT LEGAL LIABILITIES

OFFICIAL U. S. ARMY CORPS OF ENGINEERS COMMENTS

Recommendation 3.a: Ensure that amounts accrued in “Other Liabilities” and information disclosed for contingent liabilities in Note 16 to the financial statements is fully supported and agrees with information in the legal representation letters and management schedule.

Command Comments: Concur. The U.S. Army Corps of Engineers Resource Management Directorate and Office of Counsel will continue to work together to ensure all information contained in “Other Liabilities” and Note 16 is fully supported and agrees with the information presented in our legal representation letter. The completion date for this action is 2nd Quarter FY 2006.

Recommendation 3.b: Review and approve estimation methodologies and disclose, when applicable, those methodologies in Note 16 of the financial statements.

Command Comments: Concur. The U.S. Army Corps of Engineers Resource Management Directorate and Office of Counsel will work together to review and approve estimation methodologies and we will disclose, when applicable, those methodologies in Note 16. Approval will be contingent upon the Corps Office of Counsel adherence to applicable regulation and guidance for compiling contingent liabilities for financial reporting. The completion date for this action is 2nd Quarter FY 2006.

Recommendation 3.c: Disclose in Note 16 to the financial statements the dollar value of claims that legal counsel is unable to express an opinion or unable to provide an estimate or range of estimates for contingent legal liabilities, if such contingent liabilities are material to the financial statements.

Command Comments: Concur. The U.S. Army Corps of Engineers Resource Management Directorate and Office of Counsel will work together to gather and assess the dollar value of claims that legal counsel is unable to express an opinion or unable to provide an estimate or range of estimates. The completion date for this action is 2nd Quarter 2006.

Team Members

The Department of Defense Office of the Deputy Inspector General for Auditing, Defense Financial Auditing Service, prepared this report. Personnel of the Department of Defense Office of Inspector General who contributed to the report are listed below.

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